
INFORMATION ISSUES ON WALL STREET 2.0

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Billions of dollars have flooded new online marketplaces for trading private company stock. These marketplaces stand poised to become important, lasting features of the private company world as they provide a central meeting place for buyers and sellers and potentially increase the liquidity of private company stock. Increased liquidity is particularly important to investors in start-up companies, as these companies have faced longer periods of time before going public or being acquired. The new marketplaces also raise significant information issues, however, that threaten their legitimacy and efficiency. This Article is the first to examine these information issues—lack of information, asymmetric information, conflicts of interest, and insider trading—as well as possible solutions that would allow the markets to continue to evolve while promoting their integrity and investor protection goals. Specifically, the Article proposes establishing a minimum information requirement for secondary trading in private company stock and reexamining the thresholds for accredited investor status in order to ensure that market participants can fend for themselves without additional protections. The Article also examines potential responses to insider trading in these markets, arguing that a case exists for the SEC to take action in the private market context, since harm may be cognizable and the arguments for regulating insider trading are as strong in the private market arena as in the public.

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INTRODUCTION

A new generation of securities markets is emerging. Shares in private companies, previously regarded as an illiquid, out-of-reach asset class, are being traded on websites resembling stock markets. Hot demand for private shares of Facebook and other technology and social media companies has fueled the recent meteoric rise of these online markets. Their future may turn, however, on how policymakers and market participants deal with information issues in these markets, which to date have been largely unregulated. This Article is the first to examine these information issues and potential responses to them.

The new online marketplaces for trading private company stock have arisen in the context of changing market patterns. Over the past decade, the number of start-up companies entering the capital markets through an

initial public offering (IPO) has significantly dropped relative to historical norms.¹ Whereas from 1991 to 2000, nearly 2000 venture-backed companies went public, fewer than 500 did so from 2001 to 2010.² In addition, the median age of companies at the time of their IPOs has increased.³ Partially in response to the decline in IPOs, Congress recently enacted the Jumpstart Our Business Startups Act (JOBS Act).⁴ Among other things, the JOBS Act created an “on-ramp” that reduces burdens on newly public companies, but these regulatory changes are recent and their effects remain to be seen.⁵

With fewer companies going public, and with those that do staying private longer than before, early start-up employees and venture capital firms (VCs) have experienced significantly longer waiting periods before gaining liquidity in private company stock. VCs are “institutional managers of risk capital” that support the growth of innovative companies.⁶ When a VC invests in a start-up company, the investment is essentially illiquid and of uncertain value until the company matures and reaches a liquidity event.⁷ The liquidity event, typically achieved by the company’s acquisition or through an IPO, marks the payoff for the VC and its fund investors.⁸ Likewise, employees and former employees in start-up companies have depended on the company reaching a liquidity event in order to cash in on stock earned as equity compensation.⁹

Meanwhile, during this period of decline in the IPO market and increasing liquidity concerns, outside interest in buying private company stock has surged.¹⁰ Certain high-profile private companies have grown quickly and

¹ See NAT’L VENTURE CAPITAL ASS’N, 2012 NAT’L VENTURE CAPITAL ASS’N Y.B. 52 fig.5.03 [hereinafter NVCA Y.B.], available at http://www.nvca.org/index.php?option=com_content&view=article&id=257&Itemid=103 (tracking the number of IPOs each year from 1985–2011).

² *Id.*

³ *Id.*

⁴ JOBS Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

⁵ It is currently unclear whether the Act will incentivize IPOs. Although it created an “on-ramp” that eases disclosure, auditing, and other regulatory requirements for a new category known as “emerging growth” companies, *id.* §§ 101–108, it also raised the number of record holders that a private company may have before being forced to publicly report, *id.* §§ 501–502. For further discussion of the JOBS Act, see *infra* subsection I.A.2 and Part V.

⁶ NVCA Y.B., *supra* note 1, at 7.

⁷ *Id.*

⁸ *Id.*

⁹ See Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 9–10 (2012) (explaining that employees holding common shares in a start-up cannot redeem their shares at will).

¹⁰ See, e.g., Jay Yarow, *Are We Headed for Disaster with Private Stock Markets? We Talk to SharesPost CEO David Weir*, BUS. INSIDER (Mar. 22, 2011, 5:27 PM), <http://www.businessinsider.com>.

have offered the allure of potentially huge rewards when the company finally has an IPO.

These factors have set the stage for a liquidity revolution in private company stock, ignited by new online platforms such as SecondMarket and SharesPost. These platforms act as intermediaries to facilitate private company stock trading, creating centralized meeting places for potential buyers and sellers and lowering transaction costs.¹¹ Estimates of the size of this secondary market measure the total transaction volume in the billions.¹² The rapid growth of these markets suggests a potential solution to the liquidity issues in private company stock.¹³

But these new secondary markets also pose significant information issues that have not yet been explored in the legal literature.¹⁴ As this Article explains, these issues include a lack of information about the private companies whose stock is being traded, information asymmetry between buyers and sellers, and undisclosed conflicts of interest among market participants. These information issues raise concerns about the accuracy of the stocks' valuations and whether secondary investors in these markets can truly fend for themselves without additional securities laws protections. Further, concerns about insider trading hang over the community, as many of the selling shareholders are employees or former employees, and much of the material information about the companies is nonpublic.

This Article makes two main contributions to the literature. First, it identifies and analyzes the information issues in the new online secondary markets. Such issues constitute some of the most critical concerns about these markets today. Second, the Article explores potential responses to these information issues. Specifically, the Article proposes establishing a minimum information requirement for trading in private company stock

com/sharespost-interview-2011-3 ("Interest in the private markets for trading stock in hot startups is at an all time high.").

¹¹ See *infra* Section I.B.

¹² See, e.g., Richard Teitelbaum, *Facebook Drives SecondMarket Broking \$1 Billion Private Shares*, BLOOMBERG (Apr. 27, 2011), <http://www.bloomberg.com/news/2011-04-27/facebook-drives-secondmarket-broking-1-billion-private-shares.html> ("The value of all private-share transactions was \$4.6 billion in 2010, up from \$2.4 billion in 2009 . . .").

¹³ See *infra* Part II.

¹⁴ See, e.g., Ibrahim, *supra* note 9, at 4 (describing the secondary markets and arguing that they help to solve investor lock-in problems in the venture capital model); Jose Miguel Mendoza & Erik P.M. Vermeulen, *The "New" Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity* 14-15 (Lex Research Topics in Corp. Law & Econ., Working Paper No. 1, 2011), available at http://ssrn.com/abstract_id=1829835 (arguing that liquidity gaps disrupt the venture capital cycle and that secondary marketplaces for private company stock help bridge these gaps).

and reexamining accredited investor thresholds to ensure that market participants can fend for themselves without additional protections. The Article also examines potential responses to insider trading in these markets, arguing that a case for the Securities and Exchange Commission (SEC) taking action exists, as harm may be cognizable and the arguments for regulating insider trading are as strong in the private market realm as in the public. Finally, the Article situates these contributions in a broader context by examining the underlying tension between these private secondary markets and public markets.

The Article proceeds as follows. Part I provides background on the venture capital cycle and the IPO market, as well as the securities law framework in which the secondary marketplaces have grown. In addition, it details the rise of the secondary markets and their mechanics. Against that background, Part II discusses the potential benefits these markets offer. Part III analyzes the information issues in the secondary markets, including lack of information, asymmetric information, conflicts of interest, and insider trading. Part IV explores potential responses to these issues, with the aim of sparking a wider conversation. Finally, Part V deepens and contextualizes the analysis and potential responses to it by engaging with policy concerns about the public-private divide.

I. SECONDARY MARKETS FOR PRIVATE COMPANY STOCK

A. Background

The secondary markets for private company stock have developed in the context of a changing venture capital and liquidity environment, and in a regulatory framework that was largely established long before regulators could have imagined the existence of online marketplaces. This Section briefly describes the venture capital cycle and the IPO market, as well as the securities law context in which the secondary marketplaces have grown. This background helps explain the business opportunity that the secondary marketplaces have seized and lays the groundwork for understanding the information issues in these markets that this Article explores.

1. Venture Capital Cycle and Liquidity Environment

The venture capital life cycle starts with the creation of funds that raise capital from institutional and private investors interested in start-up

companies.¹⁵ A venture capital fund is typically organized as a limited partnership with the VC as the general partner and the investors as the limited partners.¹⁶ The VC selects the portfolio companies for the fund, and nurtures and supports them by contributing money and often services or advice that the companies need in order to develop.¹⁷

Venture capital funds generally have a defined period of existence, or “term,” and detailed rules about how investors in these funds can liquidate their assets in the funds at the end of that period.¹⁸ The goal is for the start-up companies to achieve successful “exits” that make a significant return on investment for the venture capital fund. Indeed, venture capital fund liquidity depends on start-ups’ exits.¹⁹ The primary exit mechanisms for start-ups are going public and being acquired in a merger transaction (sometimes referred to as an “M&A exit”).²⁰ While M&A exits are more common, industry insiders have long viewed IPOs as essential for sustaining a robust venture capital industry because of their potential for high investor returns.²¹

In the past decade, there have been significant declines in the number of companies listing on major U.S. stock exchanges and in the number of IPOs. These drops have posed substantial challenges for the venture capital

¹⁵ Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1070 (2003). For an overview of the venture capital industry, see PAUL GOMPERS & JOSH LERNER, *THE VENTURE CAPITAL CYCLE* 1-32 (2d ed. 2004).

¹⁶ Gilson, *supra* note 15, at 1071.

¹⁷ *Id.*

¹⁸ See Bernard S. Black & Ronald J. Gilson, *Does Venture Capital Require an Active Stock Market?*, J. APPLIED CORP. FIN., Winter 1999, at 36, 41 (discussing the standard limited partnership agreement and its effect on investors).

¹⁹ See Ibrahim, *supra* note 9, at 10 (noting that venture capital “exhibit[s] investor lock-in”).

²⁰ D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 317 (2005).

²¹ See Ibrahim, *supra* note 9, at 11 (“IPOs are the gold standard in VC success.”); ERNST & YOUNG, *GLOBALIZING VENTURE CAPITAL* 17, available at [http://www.ey.com/Publication/vwLUAssets/Globalizing_venture_capital_Global_venture_capital_insights_and_trends_report_2011/\\$FILE/Globalizing_venture_capital_Global_venture_capital_insights_and_trends_report_2011.pdf](http://www.ey.com/Publication/vwLUAssets/Globalizing_venture_capital_Global_venture_capital_insights_and_trends_report_2011/$FILE/Globalizing_venture_capital_Global_venture_capital_insights_and_trends_report_2011.pdf) (“M&A makes up close to 90% of US VC-backed exits in the United States.”); Richard Smith et al., *The Relative Importance of IPO and M&A Exits for Venture Capital Fund Financial Performance* 3 & n.3 (Feb. 28, 2011) (unnumbered working paper), available at <http://sites.kauffman.org/efic/resources/Venture-Capital-Fund-Financial-Performance.pdf> (examining the view that “fund success is predominantly due to IPO exits” and noting that “IPO exit valuations tend to be materially higher than M&A exit valuations”). But see DAVID WEILD & EDWARD KIM, GRANT THORNTON, *MARKET STRUCTURE IS CAUSING THE IPO CRISIS—AND MORE* 7 (2010), available at <http://www.gt.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/Files/IPO%20crisis%20-%20June%202010%20-%20FINAL.pdf> (“[T]he exit workhorse of venture capital is now the sale of a portfolio company to mostly strategic (large corporate) acquirers.”).

cycle.²² The number of companies listed on the major U.S. stock exchanges reached its highest point at over 7000 in 1997 and has been declining since.²³ Currently, about 4000 companies are listed on major U.S. stock exchanges, and experts believe that the number may decrease further.²⁴

Part of this loss stems from a precipitous drop in the number of IPOs since the crash of the Internet bubble in 2000.²⁵ In addition, changes in the public markets, such as the decimalization of stock quotes and the costs of compliance with the Sarbanes-Oxley Act of 2002, may have raised the costs associated with being public and affected possible exit strategies for private firms.²⁶ In particular, the demographics of small firm IPOs have shifted significantly—whereas IPOs raising less than \$50 million once constituted more than 80% of IPOs, that number has fallen to just 20%.²⁷ Further, the median age of companies at their time of IPO has increased in the past decade, to nearly ten years.²⁸ The average time for venture-backed companies to reach an M&A exit has also lengthened, from 1.8 years in 2000 to 5.4

²² See, e.g., NAT'L VENTURE CAPITAL ASS'N, VENTURE CAPITAL 101: WHAT IS VENTURE CAPITAL? 9-10 (2008), available at http://www.nvca.org/index.php?option=com_docman&task=doc_download&gid=357 ("[U]nless a company is acquired or goes public, there is little actual value.").

²³ Felix Salmon, Op-Ed., *Wall Street's Dead End*, N.Y. TIMES, Feb. 14, 2011, at A27.

²⁴ *Id.*

²⁵ See NVCA Y.B., *supra* note 1, at 52 fig.5.03 (providing historical data on the number of venture-backed IPOs per year and showing that the number of IPOs in 2001 and later was a fraction of the number of IPOs through the 1990s); see also Graham Bowley, *Fleeing to Foreign Shores*, N.Y. TIMES, June 8, 2011, at B1 (noting that there were only 119 IPOs in the United States in 2010, compared with 756 in 1996, and discussing several reasons why some companies are going public abroad rather than in the United States).

²⁶ See Dale A. Oesterle, *The High Cost of IPOs Depresses Venture Capital in the United States*, 1 ENTREPRENEURIAL BUS. L.J. 369, 370 (2006) (noting that Section 404 of Sarbanes-Oxley has raised the costs associated with IPOs); see also WEILD & KIM, *supra* note 21, at 22 (discussing how decimalization constrained the trading of smaller companies' stock); Francesco Bova et al., *The Sarbanes-Oxley Act and Exit Strategies of Private Firms* 28 (May 5, 2011) (unnumbered working paper), available at http://ssrn.com/abstract_id=1730242 (finding that Sarbanes-Oxley appears to have "shifted the distribution landscape from IPO to acquisitions").

²⁷ GRANT THORNTON, HOPE FOR THE SMALL IPO MARKET? 1 (2011), available at <http://www.grantthornton.com/staticfiles/GTCom/Technology/Techdashboard/Grant%20Thornton%20-%20Hope%20for%20the%20small%20IPO%20market%20FINAL.pdf>.

²⁸ NVCA Y.B., *supra* note 1, at 52 fig.5.03; see also IPO TASK FORCE, REBUILDING THE IPO ON-RAMP 6 (2011), available at http://www.sec.gov/info/smallbus/acsec/rebuilding_the_ipo_on-ramp.pdf ("The average age at IPO of companies going public between 1997 and 2001 was approximately five and a half years, compared with more than nine years for companies going public between 2006 and 2011.").

years in 2010.²⁹ Thus, in recent years, venture-backed private companies have taken longer to reach exit, and their exits are less often via IPO.

The demand for liquidity in start-up company stock builds with this longer wait time. Most venture capital funds have terms of ten years or less,³⁰ and VCs that hold private company stock may need to provide limited partners (the investors in a venture capital fund) with liquidity at the end of a fund's life cycle. In addition, long-term (as well as former) employees in a start-up may have a lot of "paper wealth" from the value of their vested stock options, but not much cash to upgrade their lifestyles or diversify their investments.³¹ Furthermore, companies may have difficulty attracting talented employees in the first place if incentive stock options are not viewed as valuable.³²

The longer exit horizon for shareholders in private start-up companies has created what some scholars have identified as a "liquidity gap" in the venture capital cycle.³³ Liquidity gaps are significant because of their potential for discouraging venture capital investment and entrepreneurship—that is, the availability of a timely exit strategy can affect whether prospective investors will commit in the first place to contributing human and capital resources to a start-up.³⁴

²⁹ Joseph Ghalbouni & Dominique Rouziès, *The VC Shakeout*, HARV. BUS. REV., July–Aug. 2010, at 21, 22.

³⁰ DAN BURSTEIN & SAM SCHWERIN, MILLENNIUM TECH. VALUE PARTNERS, L.P., *INSIDE THE GROWING SECONDARY MARKET FOR VENTURE CAPITAL ASSETS* 6 (2008), available at <http://mtvlp.com/files/resources/InsidetheGrowingSecondary.pdf>; KEN SAWYER ET AL., SAINTS CAPITAL, *A GUIDE TO SECONDARY TRANSACTIONS: ALTERNATIVE PATHS TO LIQUIDITY IN PRIVATE COMPANIES* 6 (2010), available at <http://www.saintscapital.com> (click "Download Secondary Transaction Guide").

³¹ See William K. Sjostrom, Jr., *Carving a New Path to Equity Capital and Share Liquidity*, 50 B.C. L. REV. 639, 642 (2009) ("Company founders value share liquidity because it allows them to easily diversify their portfolios.").

³² See Sean F. Reid et. al., *The Valuation of Employee Stock Options Issued by Closely Held Firms*, 13 J. LEGAL ECON. 19, 23 (2006) ("Startup firms often lack adequate cash flow to pay competitive salaries for talented employees and executives. To lure these desirable employees and executives to the startup firm, as well as retain their services as the company matures, a lucrative ESO [employee stock option] package may be the most critical component of the compensation . . .").

³³ Mendoza & Vermeulen, *supra* note 14, at 3, 10. In this context, the term "liquidity gap" refers to the period of time before a company has an exit event and investors have liquidity in their investment. This period of time is much longer than it was in the 1990s. See *supra* text accompanying notes 28–29.

³⁴ See *Industry Statistics Update: Is the Venture Capital Industry Experiencing a Capital Crisis?*, NVCA TODAY (Nat'l Venture Capital Ass'n), Sept. 7, 2008, available at <http://nvcatoday.nvca.org/index.php/industry-statistics-update-is-the-venture-capital-industry-experiencing-a-capital-crisis.html> (positing that a decrease in the number of IPOs in 2008 had led to a drop in venture capital funding); see also GOMPERS & LERNER, *supra* note 15, at 345 ("The need to ultimately exit

2. Securities Law Framework

Another important foundation for understanding the rise of the private secondary markets is the existing securities law framework. Federal securities laws govern investment in private start-up companies and any subsequent sales of stock by the investor or other shareholders. In brief, when a company sells its stock, it must either register the stock with the SEC as a public offering or structure the offering as a private placement fitting within a specified securities law exemption.³⁵ If the company goes the latter route, a registration exemption must again apply when any resale of that stock occurs.³⁶ This resale, from an existing investor to a third party, is known as a “secondary transaction.”³⁷ This Section briefly covers the relevant securities laws as they lay the groundwork for how the private secondary markets operate.

a. *Registration and Private Placements*

Congress enacted the Securities Act of 1933 (Securities Act) “to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing.”³⁸ The Securities Act provides that, unless otherwise exempt, all offers and sales of securities must be registered with the SEC.³⁹ Registration under the Securities Act is costly. Issuers must file a registration with extensive disclosures and pay fees to the SEC as well as legal and accounting fees and expenses, stock exchange listing fees, and any underwriting compensation incurred.⁴⁰ In addition to these

investments shapes every aspect of the venture capital cycle, from the ability to raise capital to the types of investments that are made.”); WEILD & KIM, *supra* note 21, at 7 (“[T]he lack of an IPO market has caused venture capitalists to avoid financing some of the more far-reaching and risky ideas that have no obvious Fortune 500 buyer.”).

³⁵ STEPHEN J. CHOI & A.C. PRITCHARD, *SECURITIES REGULATIONS: THE ESSENTIALS* 297-98 (2008).

³⁶ *Id.* at 319.

³⁷ *Id.* at 13.

³⁸ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) (citing H.R. REP. NO. 73-85, at 1-5 (1933)).

³⁹ 15 U.S.C. § 77e(c) (2006). “Offer” and “sale” are interpreted broadly to include “every attempt or offer to dispose of, or solicitation of an offer to buy, a security . . .” *Id.* § 77b(a)(3); see also Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 907 (2011) (noting the broad sweep of Section 5 of the Securities Act).

⁴⁰ Heminway & Hoffman, *supra* note 39, at 908.

registration expenses, the ongoing costs of being a public reporting company are high and include costs associated with ongoing reporting under the Securities Exchange Act of 1934 (Exchange Act), regulatory compliance, and being in the public eye.⁴¹

If a private company wishes to avoid registration, it must structure sales of its securities to fit within the safe harbor of an exemption. Exemptions are based on the general notion that registration safeguards are unnecessary for the adequate protection of investors and markets for certain limited offerings.⁴²

The primary statutory exemption for private placements is Section 4(2) of the Securities Act, which exempts “transactions by an issuer not involving any public offering.”⁴³ The statute does not explicitly define “public offering.”⁴⁴ In the seminal case on the topic, *SEC v. Ralston Purina Co.*, the Supreme Court clarified that the applicability of the exemption “should turn on whether the particular class of persons affected needs the protection of the [Securities] Act,” which is designed “to protect investors by promoting full disclosure of information thought necessary to informed investment

⁴¹ *Id.* at 910 n.147; see also JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 156 (6th ed. 2009) (discussing some of the indirect costs of an IPO). For “emerging growth companies” with less than \$1 billion in total annual gross revenues, the JOBS Act reduced regulatory burdens associated with going public by creating a transitional on-ramp that phases in certain compliance measures over a period of time after the company’s IPO. JOBS Act, Pub. L. No. 112-106, §§ 101–108, 126 Stat. 306, 307–13 (2012). Such measures include lowered requirements for audited financial statements at the time of IPO, limited executive compensation disclosure, phase-in periods for certain financial accounting standards, and exemptions from auditor attestations under Sarbanes-Oxley and “say-on-pay” votes. *Id.* §§ 102–104. The JOBS Act’s effect on the U.S. IPO market remains to be seen. See, e.g., Liz Gannes, *How Will the JOBS Act Affect Tech IPOs?*, ALLTHINGSID (Apr. 5, 2012, 10:39 AM PT), <http://allthingsid.com/20120405/how-will-the-jobs-act-affect-tech-ipos> (“[T]he consensus from everyone I talked to is that the JOBS Act is more of a reducer of friction than a significant change to the incentives around going public.”). But see PHILLIP J. KARDIS II ET AL., K&L GATES, CAPITAL MARKETS RELIEF: JOBS (JUMPSTART OUR BUSINESS STARTUPS) ACT EASES REGULATORY BARRIERS TO IPOs AND OTHER CAPITAL RAISING ALTERNATIVES 3 (2012), available at <http://www.klgates.com/capital-markets-relief-jobs-jumpstart-our-business-startups-act-eases-regulatory-barriers-to-ipos-and-other-capital-raising-alternatives-04-05-2012> (expecting, as a result of the JOBS Act, “an increase in the number of small IPOs compared to the diminished levels of recent years”).

⁴² Heminway & Hoffman, *supra* note 39, at 928; see also H.R. REP. NO. 73-85, at 5 (noting the inefficiency of requiring registration “where there is no practical need for [application of the Securities Act] or where the public benefits are too remote”); C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081, 1133 (“As a historical matter, Congress did not design the securities laws to protect investors capable of protecting themselves.”).

⁴³ 15 U.S.C. § 77d(2). This Article refers to the securities laws in the customary manner to date, with pre-JOBS Act numbering.

⁴⁴ Heminway & Hoffman, *supra* note 39, at 912.

decisions.”⁴⁵ The Court thus reasoned that “[a]n offering to those who are shown to be able to fend for themselves is a transaction not involving any public offering.”⁴⁶

Two factors help determine the ability to fend for oneself: (1) the offeree’s knowledge or sophistication in investment matters and (2) his access to information.⁴⁷ In sum, sophisticated offerees with access to information similar to that provided in a registration statement would not need the protections of the Securities Act, and a transaction constituted of such offerees would not be a public offering.⁴⁸

Since *Ralston Purina*, the SEC has promulgated Regulation D⁴⁹ to provide additional clarity in this area and to mitigate the uncertainty inherent in Section 4(2)’s private placement exemption.⁵⁰ Regulation D includes Rule 506, which provides a safe harbor for offerings limited to “accredited investors.”⁵¹ Rule 501 defines “accredited investors” as specified institutional investors such as banks, and individuals with a net worth over \$1 million or annual income over \$200,000 (or \$300,000 joint annual income) for the previous two years.⁵² Accredited status is thus a proxy for being able to fend for oneself, objectively determined by institutional identity, or the net worth or income of the individual investor.

b. *Exemptions for Resales*

Privately placed securities are not freely tradable, and any “secondary transaction” in which an existing shareholder sells to a third party must

⁴⁵ 346 U.S. 119, 124, 125 (1953).

⁴⁶ *Id.* at 125 (internal quotation marks omitted).

⁴⁷ *See id.* at 125-27 (analyzing the investor’s access to information); Heminway & Hoffman, *supra* note 39, at 914 & n.173 (noting that courts have interpreted “sophistication” as the “financial and business knowledge that allows them to appreciate the risks of the investment”).

⁴⁸ *Cf. Ralston Purina*, 346 U.S. at 125-27.

⁴⁹ 17 C.F.R. §§ 230.500–508 (2012).

⁵⁰ *See* Heminway & Hoffman, *supra* note 39, at 915 (highlighting the clarifying purpose of Regulation D).

⁵¹ 17 C.F.R. § 230.506(b)(2)(ii). Rule 506 allows the issuer to include up to thirty-five unaccredited investors as well, provided the issuer reasonably believes they are sophisticated—meaning the investor “has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment,” either alone or with the assistance of a purchaser representative. *Id.*

⁵² *Id.* § 230.501(a)(1)–(6). Congress recently amended the net worth requirement to exclude the value of the investor’s primary residence. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 413(a), 124 Stat. 1376, 1577 (2010); *see also* Net Worth Standard for Accredited Investors, 76 Fed. Reg. 81,793 (Dec. 29, 2011) (codified at 17 C.F.R.).

likewise be structured to fit within an available exemption from registration.⁵³ One of the most commonly relied-upon exemptions for secondary transactions of private company stock is Rule 144, a safe harbor under Section 4(1) of the Securities Act, which exempts transactions “by any person other than an issuer, underwriter, or dealer.”⁵⁴ Rule 144 allows for the sale of restricted securities provided the seller has held them for a certain period of time—at least one year for nonreporting company stock.⁵⁵ Rule 144A exempts resales of securities with no required holding period if the buyer is a “qualified institutional buyer” (QIB), which is an institution that in the aggregate owns and invests at least \$100 million in securities of nonaffiliated entities.⁵⁶ Information requirements apply under Rule 144A as well as under Rule 144 when the seller is an affiliate of the company whose stock is being sold.⁵⁷ Nonaffiliate sellers of private company stock are subject to a holding period, but are not subject to the information requirement under Rule 144.⁵⁸ Finally, the so-called “Section 4(1½)” exemption may exempt the resale of restricted securities in a transaction structured similarly to a private

⁵³ 17 C.F.R. § 230.502(d); *see also* William K. Sjostrom, Jr., *The Birth of Rule 144A Equity Offerings*, 56 UCLA L. REV. 409, 418-20 (2008) (discussing the securities law framework for resale of privately placed securities).

⁵⁴ 15 U.S.C. § 77d(1) (2006). If a seller meets the requirements of Rule 144, he or she will not be deemed an “underwriter” in connection with the resale of the restricted securities. 17 C.F.R. § 230.144 (preliminary note).

⁵⁵ 17 C.F.R. § 230.144(d)(1)(ii).

⁵⁶ *Id.* § 230.144A(a)(1)(i).

⁵⁷ *See id.* §§ 230.144(b)(2) & 230.144(c)(2) (requiring disclosure of information about a private company issuer upon request, including a brief description of the company’s business, products, and services, as well as certain financial statements, as required in 17 C.F.R. § 240.15c2-11(a)(5)); *id.* § 230.144A(d)(4)(i) (requiring an issuer that is not an Exchange Act reporting company, a foreign issuer exempt from reporting, or a foreign government, to provide certain information upon request, including a brief description of the company’s business, products, and services, as well as financial information for its two preceding fiscal years). Rule 144 defines “affiliate” as any “person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer.” *Id.* § 230.144(a)(1). Rule 144 does not define “control,” but Rule 405 of Regulation C establishes an identical definition of “affiliate” and defines “control” as “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.” *Id.* § 230.405. An individual’s status as an affiliate is a fact-specific inquiry, determined by considering relevant facts in accordance with Rule 405. An individual’s status as a director, officer, or 10% shareholder is relevant, but is only “one fact which must be taken into consideration.” American-Standard, SEC No-Action Letter, 1972 WL 19628 (Oct. 11, 1972).

⁵⁸ 17 C.F.R. § 230.144(b)(1)(ii); *Revisions to Rules 144 and 145: A Small Entity Compliance Guide*, SEC, (Feb. 15, 2008), <http://www.sec.gov/info/smallbus/secg/rules144-145-secg.htm>.

placement.⁵⁹ Section 4(1½) extends the logic of Sections 4(1) and 4(2) to resales by non-issuers—that is, it exempts someone other than an issuer, underwriter, or dealer who sells to purchasers able to “fend for themselves” within the meaning of *Ralston Purina*.⁶⁰ Although not expressly in the Securities Act or formally adopted by the SEC, Section 4(1½) has been recognized by the SEC in interpretive releases.⁶¹

Considering the legal restrictions in total, “[t]he net effect . . . is that the restricted stock is less liquid or more costly to resell than freely tradable stock.”⁶² Buyers and sellers incur search and bargaining costs to identify potential transaction partners, as well as compliance and trade delay costs created by the exemption requirements.⁶³

c. *The Record Holder Rule*

Finally, start-up companies may be concerned about resale of their stock because such sales can increase the number of shareholders on the company’s record. If a shareholder sells a partial stake, that one shareholder might become two or more. Thus, private companies may be concerned about eventually triggering registration requirements under Section 12(g) of the Exchange Act.⁶⁴ Until April 2012, Section 12(g) provided that any company with total assets exceeding \$10 million and a class of equity security “held of

⁵⁹ See EDWARD BRODSKY & M. PATRICIA ADAMSKI, *LAW OF CORPORATE OFFICERS AND DIRECTORS* § 11:12 (2011); Carl W. Schneider, *Section 4(1½)—Private Resales of Restricted or Control Securities*, 49 OHIO ST. L.J. 501, 504 (1988) (tracking the statutory origins of the exemption). Section 4(1½)’s name comes from the idea that it combines Section 4(1)’s exemption for “transactions by any person other than an issuer, underwriter, or dealer” with Section 4(2)’s exemption for “transactions by an issuer not involving any public offering.” Robert A. Prentice & Mark E. Roszkowski, *The Sale of Business Doctrine: New Relief from Securities Regulation or a New Haven for Welshers?*, 44 OHIO ST. L.J. 473, 510 n.244 (1983).

⁶⁰ See JIM BARTOS, *UNITED STATES SECURITIES LAW* 85 (3d ed. 2006) (“[T]he exemption is somewhere between Section 4(1) . . . and Section 4(2)”; see also *supra* notes 45–48 and accompanying text).

⁶¹ See, e.g., *Employee Benefit Plans*, Securities Act Release No. 6188, 19 SEC Docket 465, 496 n.178 (Feb. 19, 1980) (explaining that the Section 4(1½) “hybrid exemption” is “clearly within [the] intended purpose” of the Securities Act); see also *Ackerberg v. Johnson*, 892 F.2d 1328, 1335 n.6 (8th Cir. 1989) (recognizing the Section 4(1½) exemption as legitimate).

⁶² Sjöström, *supra* note 53, at 420.

⁶³ *Id.* at 422.

⁶⁴ For these registration requirements, see 15 U.S.C. § 781(g) (2006), amended by JOBS Act, Pub. L. No. 112-106, §§ 501–502 & 601, 126 Stat. 306, 325, 326 (2012). In addition to crossing the Section 12(g) threshold, a company also becomes subject to the Exchange Act by listing securities on a national securities exchange or by making a registered public offering under the Securities Act. 15 U.S.C. §§ 781(a) & 780(d).

record by five hundred or more . . . persons” must register such security under the Exchange Act.⁶⁵

This rule has had the practical effect of forcing some companies to become public reporting companies earlier than they would otherwise choose. The classic example is Google, which reached the threshold in 2003 and went public in early 2004, stating, “by law, certain private companies must report as if they were public companies. The deadline imposed by this requirement accelerated our decision [to go public].”⁶⁶ More recently, Facebook found itself in a similar position.⁶⁷

Congress added Section 12(g) to the Exchange Act in 1964 to protect investors by mandating disclosures from companies with “sufficiently active trading markets and public interest.”⁶⁸ It was aimed at private trading that had grown in the over-the-counter market.⁶⁹ Congress used company assets and the number of shareholders as a proxy, or guideline, for determining which companies should be required to publicly report.⁷⁰

While Congress has amended Section 12(g) over the years to raise the asset threshold,⁷¹ the original 500-record-holders threshold remained unchanged until the JOBS Act increased it to 2000, provided that no more than 499 of those holders are unaccredited investors.⁷² Further, the JOBS Act excludes from the increased limit those holders who obtained equity under the company’s equity compensation plans.⁷³ The higher threshold

⁶⁵ 15 U.S.C. § 78l(g). The measurement date for the threshold is the last day of the company’s fiscal year. *Id.* If it exceeds the threshold, the company has 120 days to register. *Id.*

⁶⁶ Google, Inc., Registration Statement (Form S-1), at iv (Apr. 29, 2004).

⁶⁷ See William K. Sjostrom, Jr., *Questioning the 500 Equity Holders Trigger*, 1 HARV. BUS. L. REV. ONLINE 43, 44 (2011), <http://www.hblr.org/?p=1028> (noting that Facebook planned to surpass 499 owners in 2012, the year it went public).

⁶⁸ Reporting by Small Issuers, Exchange Act Release No. 23,407, 51 Fed. Reg. 25,369 (July 14, 1986).

⁶⁹ S. REP. NO. 88-379, at 1 (1963); Steven M. Davidoff, *Facebook and the 500-Person Threshold*, N.Y. TIMES DEALBOOK (Jan. 3, 2011, 4:03 PM), <http://dealbook.nytimes.com/2011/01/03/facebook-and-the-500-person-threshold/>; see also H.R. REP. NO. 88-1418, at 1 (1964) (reporting that Section 12(g) was intended to “extend to investors in certain over-the-counter securities the same protection now afforded to those in listed securities”).

⁷⁰ See Michael D. Guttentag, *Patching a Hole in the JOBS Act: How and Why to Rewrite the Rules that Require Firms to Make Periodic Disclosures*, 88 IND. L.J. (forthcoming 2013) (manuscript at 18-21) (on file with author) (detailing the history of Section 12(g)).

⁷¹ 15 U.S.C. § 78l(g) (2006). The total assets threshold was originally \$1 million in 1964, increased to \$5 million in the 1980s, and increased to \$10 million in 1996. Relief from Reporting by Small Issues, Exchange Act Release No. 34-37157, 61 Fed. Reg. 21,354 (May 9, 1996).

⁷² JOBS Act, Pub. L. No. 112-106, § 501, 126 Stat. 306, 325 (2012). The Act refers to accredited status as a term defined by the SEC. *Id.*

⁷³ *Id.* § 502.

may give private companies more control over the timing of an IPO and may make them less sensitive to the effect of stock options and stock resales on the number of company record holders.⁷⁴

With this background on the venture capital cycle, the liquidity environment in private company stock, and the relevant securities law framework, the next Section turns to the private secondary markets.

B. *The Rise of the Secondary Markets and How They Work*

The combination of the lengthened period of time companies stay private, securities law exemptions for the resale of restricted stock, and information technology has created a unique business opportunity. And new marketplaces for trading private shares have emerged to seize it. The two largest of these markets are SecondMarket and SharesPost.⁷⁵

These online markets, themselves private companies, are modernizing the secondary transaction process. While securities law exemptions allowing trades in private company stock have existed for a long time, SharesPost and SecondMarket have innovated by establishing online marketplaces for this trading, acting as intermediaries to facilitate trades between potential buyers and sellers. They have user-friendly websites that have been fueled by demand for pre-IPO stock in highly visible venture capital-backed companies such as Facebook, Twitter, Groupon, LinkedIn, and Zynga.⁷⁶ And the online platforms were designed with securities laws in mind⁷⁷—

⁷⁴ Cf. *The JOBS Act (Jumpstart Our Business Startups Act)—What Does It Mean for Entrepreneurs?*, COOLEY LLP (Apr. 2, 2012), <http://www.cooley.com/jobs-act-what-does-it-mean> (“Because companies will be able to stay private longer, it is possible that we will see a larger, more robust market for secondary sales of shares of private companies. However, we expect many entrepreneurs and investors to continue to explore increasingly restrictive policies with respect to secondary sales of their companies’ securities, particularly on secondary exchanges.”).

⁷⁵ A handful of precursors and alternatives to SecondMarket and SharesPost exist. See generally WEILD & KIM, *supra* note 21, at 17 (listing various precursors such as the PORTAL Alliance and NYPPEX); see also Ben Popper, *Gate Technologies Expands, Challenges SecondMarket’s Model*, N.Y. OBSERVER (Feb. 9, 2011, 12:50 PM), <http://www.observer.com/2011/02/gate-technologies-expands-challenges-secondmarkets-model> (describing newcomer Gate Technologies). HedgeBay, another secondary market, is a specialty service for hedge fund interests. HEDGEBAY TRADING, <http://www.hedgebay.com> (last visited Oct. 11, 2012).

⁷⁶ The companies “listed” on SecondMarket and SharesPost tend to be mature, venture-backed companies. SharesPost describes the companies on its site as typically valued at \$100 million or more, having \$10 million or more of annual revenue, and having been in business for five or more years. *Frequently Asked Questions*, SHARESPOST, <https://www.sharespost.com/pages/faqs> (last visited Oct. 11, 2012) [hereinafter *FAQ*, SHARESPOST].

⁷⁷ See Gennine Kelly, *Private Exchanges in ‘Dialogue’ with SEC: President SharesPost*, CNBC (Dec. 29, 2010, 3:20 PM ET), http://www.cnbc.com/id/40842540/Private_Exchanges_

requiring buyers to be QIBs or “accredited investors” and requiring sellers to have held their shares for at least a year before selling.⁷⁸ The transaction process through these online platforms is customized, rather than standardized and immediate as on public markets. Nonetheless, the very existence of a known marketplace may reduce transaction costs and foster network benefits as trading becomes easier and cheaper.⁷⁹

Sellers in these markets include entrepreneurs, employees, and former employees who hold start-up stock and want to diversify or generate cash for some other reason, as well as VCs and other early-stage investors who wish to fund other companies or return cash to limited partners.⁸⁰ The marketplaces have reached out to potential sellers, and sellers are also finding the marketplaces on their own.⁸¹ Buyers in these markets typically include individuals, existing investors, late-stage VCs, hedge funds, private equity firms, and institutional investors.⁸²

This Section explains in more detail what these markets are, how they work, and how they have evolved in the short time since their inception.

in *Dialogue With SEC President SharesPost* (quoting SharesPost President Greg Brogger, who said that SharesPost has “taken all those same securities laws that have always protected investors buying private company securities and . . . wired them into a web interface”).

⁷⁸ *FAQ*, SHARESPOST, *supra* note 76; *Legal*, SHARESPOST, <https://www.sharespost.com/pages/legal> (last visited Oct. 11, 2012).

⁷⁹ See *infra* Part II. “Network benefits” refers to the notion of goods or markets in which value is increased as others use the good or participate in the market. Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 772 (1995). See generally Mark A. Lemley & David McGowan, *Legal Implications of Network Economic Effects*, 86 CALIF. L. REV. 479 (1998). The private secondary markets become more useful or valuable to their users as others also trade because more buyers and sellers in the market increases liquidity.

⁸⁰ See *SecondMarket’s Q1 2012 Private Company Report*, SECONDMARKET (May 3, 2012), <https://www.secondmarket.com/discover/reports/q1-2012-private-company-report> [hereinafter *Q1 2012*, SECONDMARKET] (listing sellers by type); *SecondMarket’s 2011 Year End Private Company Report*, SECONDMARKET (Jan. 19, 2012), <https://www.secondmarket.com/discover/reports/secondmarkets-2011-year-end-private-company-report> [hereinafter *2011 Year End*, SECONDMARKET] (same); see also BURSTEIN & SCHWERIN, *supra* note 30, at 2-3 (listing reasons why sellers may sell stock in the secondary markets).

⁸¹ See Yarow, *supra* note 10 (reporting that SharesPost has approached and been approached by potential sellers).

⁸² SAWYER ET AL., *supra* note 30, at 10-11; *2011 Year End*, SECONDMARKET, *supra* note 80; *Q1 2012*, SECONDMARKET, *supra* note 80; see also *Institutional Investor Survey Results*, SECONDMARKET, <https://www.secondmarket.com/discover/resource/institutional-investor-survey-results> (last visited Oct. 11, 2012) (reporting that “most investors with exposure to private companies have either directly transacted in the private stock secondary market or [have done so] through a secondary fund”). Just prior to the date of this publication, SecondMarket released third quarter data indicating that companies are engaging in share buy-back programs and that an increasing percentage of sellers are current employees. See *Q3 2012 SecondMarket Report*, SECONDMARKET (Nov. 9, 2012), <https://www.secondmarket.com/education/reports/q3-2012-secondmarket-report>.

This Section contributes to the sparse literature on these markets and lays the groundwork for subsequently exploring the beneficial role they may play in the venture capital cycle as well as the troubling information issues they raise.

1. SecondMarket

SecondMarket is a marketplace that matches buyers and sellers of alternative investments. Barry Silbert, a young investment-banker-turned-first-time-entrepreneur, founded SecondMarket in 2004 with an initial focus on restricted securities in public companies.⁸³ In 2008, the company started to grow significantly, developing an early version of its online platform and expanding to include other asset classes, including private company stock, which has since become a focal point of the site.⁸⁴ In 2011, private stock trades increased 55% on the platform and totaled \$558 million in transactions.⁸⁵ Over a billion dollars in private stock transactions have been completed through the site since its launch.⁸⁶ It is registered as a broker-dealer, a member of the Financial Industry Regulatory Authority (FINRA), and as an “alternative trading system” (ATS) under Regulation ATS.⁸⁷

⁸³ *Legislative Proposals to Facilitate Small Business Capital Formation and Job Creation: Hearing Before the Subcomm. on Capital Mkts. and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 112th Cong. 112 (2011) (statement of Barry E. Silbert, CEO, SecondMarket); see also Brad Stone, *Silicon Valley Cashes Out Selling Private Shares*, BLOOMBERG BUSINESSWEEK (Apr. 21, 2011), http://www.businessweek.com/magazine/content/11_18/b4226070179043.htm (recounting SecondMarket's origins as a firm called Restricted Stock Partners which sold illiquid securities).

⁸⁴ See *A New Vision for Capital Markets*, STAN. TECH. VENTURES PROGRAM ENTREPRENEURSHIP CORNER (Apr. 13, 2011), <http://ecorner.stanford.edu/authorMaterialInfo.html?mid=2698>, at 9:30-11:23 [hereinafter Silbert] (discussing SecondMarket's shift in focus from restricted securities to additional asset classes); see also *Company Overview*, SECONDMARKET, <http://www.secondmarket.com/about-us> (last visited Oct. 11, 2012) [hereinafter *About SecondMarket*] (charting the asset classes in SecondMarket's history, including private venture-backed companies, private community banks, fixed income products, bankruptcy claims, and public equity); Teitelbaum, *supra* note 12 (detailing Barry Silbert's leading role in the market for private company, social-media stock).

⁸⁵ Paul Sloan, *SecondMarket: Private Stock Trades Jump 55% in 2011*, CNET (Jan. 19, 2012, 10:30 AM PST), http://news.cnet.com/8301-1023_3-57361897-93/secondmarket-private-stock-trades-jump-55-in-2011.

⁸⁶ See *2011 Year End*, SECONDMARKET, *supra* note 80.

⁸⁷ *About SecondMarket*, *supra* note 84. An “[a]lternative trading system” is defined as “any organization, association, person, group of persons, or system . . . [t]hat constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange” 17 C.F.R. § 242.300(a)(1) (2012); see also *id.* § 240.3b-16(a) (defining “exchange”); Mark Borrelli, *Market Making in the Electronic Age*, 32 LOY. U. CHI. L.J. 815, 853-54 (2001) (discussing how Regulation ATS imposes minimal regulations on low-volume electronic trading).

The average sale on SecondMarket is reportedly \$2 million.⁸⁸ Pre-IPO Facebook stock was the most actively traded security on the site in its first few years, and it remains to be seen how Facebook's transition into a public company will affect the secondary trading marketplace.⁸⁹

SecondMarket claims to have over 100,000 participants, over 20,000 of whom have verified themselves as accredited investors.⁹⁰ In 2011, about 27% of buyers were individuals and 73% were institutional investors.⁹¹ On the selling side, nearly 80% of sellers were former employees and 11% of sellers were current employees.⁹²

One of the key ways in which SecondMarket has evolved since its formation is by moving to a model in which it significantly involves the issuer company.⁹³ SecondMarket no longer simply connects buyers and sellers in a

systems and does not subject them to the "rigors of registration as an exchange"); Jonathan R. Macey & Maureen O'Hara, *Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective*, 28 J. LEGAL STUD. 17, 37-42, 45-49 (1999) (comparing the economic roles played by ATSs and exchanges).

⁸⁸ Douglas MacMillan, *Facebook, Zynga Impose Fees on Private Sales of Shares*, BLOOMBERG (Oct. 11, 2010, 1:21 PM), <http://www.bloomberg.com/news/2010-04-21/linkedin-zynga-may-use-stock-sale-limits-to-curb-preipo-value-inflation.html>.

⁸⁹ See Maureen Farrell, *Facebook IPO Shrinks Private Trading Market*, CNNMONEY (Feb. 3, 2012, 1:23 PM), http://money.cnn.com/2012/02/03/markets/facebook_second_market/index.htm (noting that the majority of the \$1.1 billion of stock trades on SecondMarket was in Facebook stock and questioning SecondMarket's prospects); Lee Spears, *SecondMarket Acts to Offset Facebook Fees Selling Wine, Art*, BLOOMBERG (May 17, 2012), <http://www.bloomberg.com/news/2012-05-17/secondmarket-acts-to-offset-facebook-fees-selling-wine> (noting that commissions on Facebook trades may have generated almost a third of the company's overall revenue); Teitelbaum, *supra* note 12 (noting Facebook stock accounted for 40% of all SecondMarket private company stock trades as of March 2011).

⁹⁰ See Comment Letter from Annemarie Tierney, General Counsel, SecondMarket, to SEC (May 25, 2012), available at <http://www.sec.gov/comments/jobs-title-ii/jobtitleii-16.pdf> (discussing the buyer verification process for SecondMarket's pool of individual and institutional investors).

⁹¹ 2011 Year End, SECONDMARKET, *supra* note 80; Steven Russolillo, *SecondMarket Brags About 2011 Results, But What Happens After Facebook Goes Public?*, WALL ST. J. MARKETBEAT (Jan. 19, 2012, 3:17 PM), <http://blogs.wsj.com/marketbeat/2012/01/19/secondmarket-brags-about-2011-results-but-what-happens-after-facebook-goes-public>; see also Q1 2012, SECONDMARKET, *supra* note 80 (providing updated figures stating that 18.8% of buyers in the first quarter 2012 were individuals and 70.8% were asset managers, hedge funds, family offices, and mutual funds).

⁹² Russolillo, *supra* note 91; see also 2011 Year End, SECONDMARKET, *supra* note 80; Q1 2012, SECONDMARKET, *supra* note 80 (providing updated data for the first quarter 2012). But see *supra* note 82.

⁹³ See Silbert, *supra* note 84, at 24:40, 32:25 (discussing how and why SecondMarket works directly with issuers); cf. Steven M. Davidoff, *Private Markets Offer Valuable Service But Little Disclosure*, N.Y. TIMES DEALBOOK (Nov. 22, 2011, 4:37 PM), <http://dealbook.nytimes.com/2011/11/22/private-markets-offer-valuable-service-but-little-disclosure> (noting that SecondMarket changed its business model in 2010 to require issuers, except for Facebook, to post two years of audited financial information).

common marketplace as it did when it started. Rather, it now works with companies to develop “customized liquidity program[s]” for them to control the trading process.⁹⁴ SecondMarket allows the issuer company to decide whether to approve trading, when to allow it, the types of sellers and investors eligible, how much stock can be traded, and how the share price is set (e.g., as a fixed-price tender, negotiated, or in a Dutch auction).⁹⁵ SecondMarket has also developed a tool that “lets private companies interact with potential investors” and track their interest.⁹⁶

Accredited investors can participate by completing a profile online, at which point they can access company profiles and submit statements indicating interest to buy or sell private shares.⁹⁷ These investors will then receive notifications of pertinent investment opportunities, if available.⁹⁸ SecondMarket typically charges a transaction fee between three and five percent, which varies depending on the type and complexity of the transaction.⁹⁹

⁹⁴ Barry Silbert, *Not All Markets Are Created Equal*, TECHCRUNCH (Mar. 28, 2012), <http://techcrunch.com/2012/03/28/secondmarket-sec>. This model perhaps responds to some companies’ reservations about secondary trading. See Stone, *supra* note 83 (discussing why some companies might not support participation in secondary markets and the restrictions some companies have imposed).

⁹⁵ For discussions of how SecondMarket works with private companies, see Kevin Kelleher, *The SEC’s Challenge in the Secondary Market*, CNNMONEY (Jan. 4, 2011, 1:34 PM), <http://tech.fortune.cnn.com/2011/01/04/the-secs-challenge-in-the-secondary-market>; *Private Company Secondary Market*, SECONDMARKET, <http://www.secondmarket.com/private-company> (last visited Oct. 11, 2012) [hereinafter *Private Company*, SECONDMARKET]; Evelyn M. Rusli, *Beyond Facebook, SecondMarket Opens Its Doors to Thousands*, N.Y. TIMES DEALBOOK (Mar. 10, 2011, 3:01 PM), <http://dealbook.nytimes.com/2011/03/10/beyond-facebook-secondmarket-opens-its-doors-to-thousands>; and Barry Silbert, Comment to *SecondMarket: Why Wasn’t SecondMarket Part of the SharesPost/Secondary Market SEC Action Today?*, QUORA (Mar. 15, 2012, 6:55 PM), <http://www.quora.com/SecondMarket/Why-wasnt-Secondmarket-part-of-the-SharesPost-secondary-market-SEC-action-today> [hereinafter Silbert, *SecondMarket*].

⁹⁶ Nitasha Tiku, *The Future of SecondMarket in a World Without Private Facebook Shares*, BETABEAT (Feb. 3, 2012, 11:28 AM), <http://betabeat.com/2012/02/03/secondmarket-facebook-ipo-barry-silbert-02032012>.

⁹⁷ See *Private Company*, SECONDMARKET, *supra* note 95; *Q1 2012*, SECONDMARKET, *supra* note 80.

⁹⁸ *Private Company*, SECONDMARKET, *supra* note 95.

⁹⁹ See SecondMarket Admin, Post to *SecondMarket Support: How Does SecondMarket Make Money?*, SECONDMARKET (Dec. 6, 2010, 3:52 PM), <http://support.secondmarket.com/entries/351048-how-does-secondmarket-make-money> (“SecondMarket will earn a fee based on the notional value of the transaction. The fee is determined on a case-by-case basis depending on many factors, including, but not limited, to [sic] the asset type, value of the asset, and complexity of the transaction.”); see also Kelleher, *supra* note 95 (“SecondMarket charges a transaction fee between 3% and 5% of the proceeds raised from all private equity transactions.”); Teitelbaum, *supra* note 12 (“SecondMarket could broker \$1 billion in private-company shares in 2011, taking fees of from 3 to 5 percent on each trade.”). Other fee arrangements may exist as well. See Felix Salmon, *SecondMarket’s Unnecessary Facebook Fund*, REUTERS (Mar. 20, 2012, 1:45 PM), <http://blogs>.

While trading in the private stock of consumer internet and social media companies has been a focal point of the site in recent years, SecondMarket continues to evolve. Companies beyond venture-backed companies, and in different industries, have started to participate on the platform.¹⁰⁰ In addition, the company may start to facilitate primary market activity, “helping companies to sell shares directly to institutional investors as an alternative to venture capital.”¹⁰¹

Commentators have reported varying levels of information disclosure on SecondMarket. While one news article reported that companies can disclose “[a]s much or as little as they want” and that “SecondMarket provides its customers only the financial data that firms are willing to provide,”¹⁰² another article reported that SecondMarket “require[s] companies to provide two years of audited financials and other information to potential bidders” (with the exception of pre-IPO Facebook stock, for which no information requirement existed).¹⁰³ In 2011, SecondMarket’s CEO stated that information standards have been evolving. By that time, SecondMarket required disclosure of financial statements, balance sheets, a capitalization table, and any risk factors if the seller was an insider such as a director, affiliate, or manager.¹⁰⁴ But the CEO noted a “lower level of requirement” for sellers who were not insiders.¹⁰⁵ To provide the private company information to potential investors, SecondMarket maintains password-protected online “data rooms” where such investors can view posted documents.¹⁰⁶ The company has also started to offer, and even to pay for,

reuters.com/felix-salmon/2012/03/20/secondmarkets-unnecessary-facebook-fund (noting that buyers of pre-IPO Facebook shares on SecondMarket paid a three percent fee at the time of purchase and a second three percent fee when they got the stock).

¹⁰⁰ See Kelleher, *supra* note 95 (“SecondMarket sees the secondary-transaction market growing beyond a niche as private companies in other industries like biotech or consulting start participating.”); Silbert, *supra* note 84, at 46:30 (discussing how SecondMarket is expanding its private company market beyond venture capital-backed companies).

¹⁰¹ Kelleher, *supra* note 95.

¹⁰² Teitelbaum, *supra* note 12.

¹⁰³ Davidoff, *supra* note 93; see also Barry Silbert, CEO of SecondMarket, NPR (May 11, 2012), at 22:25–23:14, <http://www.npr.org/2012/05/11/152523244/barry-silbert-ceo-of-secondmarket> (noting that investors were willing to make certain investments, particularly in Facebook, with limited information).

¹⁰⁴ See Silbert, *supra* note 84, at 35:55–36:38 (discussing information disclosures on SecondMarket).

¹⁰⁵ *Id.* at 36:45. But see *id.* (“[W]e essentially encourage, and we will start requiring, companies to provide at the very least audited financials and a balance sheet.”).

¹⁰⁶ Kelleher, *supra* note 95; see also *Secondary Market for Private Shares: Overview and Challenges*, ROCK CTR. FOR CORP. GOVERNANCE, STAN. U. (May 4, 2011), at 29:45, <http://>

analyst coverage of certain companies.¹⁰⁷ It does not, however, publicly disclose historical pricing or valuation information from the site.¹⁰⁸

In addition, SecondMarket has integrated aspects of social media into its technology.¹⁰⁹ Participants can create their own profiles that include information about their previous investments and investment interests.¹¹⁰ They can also “add companies to their ‘watch lists,’” “create a network of ‘trusted’ investors” on the platform, and receive updates on their investments and auctions.¹¹¹ The updates currently include digests of publicly available information, such as news and filings.¹¹² SecondMarket states that it also provides updates on “[n]ew investors and funding rounds.”¹¹³

2. SharesPost

SharesPost also focuses on the secondary trading of private company stock, and has expanded into facilitating primary offerings.¹¹⁴ Founded in 2009 by Greg Brogger, an entrepreneur and former Silicon Valley securities lawyer, SharesPost claims to have more than 60,000 members¹¹⁵ and a

rockcenter.stanford.edu/2011/05/04/secondary-market-for-private-shares-overview-and-challenges-2/ (featuring Annemarie Tierney of SecondMarket discussing its online data rooms).

¹⁰⁷ See Silbert, *supra* note 84, at 36:58 (discussing the evolution of SecondMarket’s analyst coverage).

¹⁰⁸ Silbert, *SecondMarket*, *supra* note 95.

¹⁰⁹ *E.g.*, Silbert, *supra* note 84, at 24:15.

¹¹⁰ Press Release, SecondMarket, SecondMarket Unveils Next Generation Investment Platform (Mar. 14, 2011), <https://www.secondmarket.com/discover/pressreleases/secondmarket-unveils-next-generation-investment-platform>.

¹¹¹ *Id.*

¹¹² See Rusli, *supra* note 95 (“SecondMarket will aggregate publicly available data, including filings, and encourage companies to submit additional financial information.”).

¹¹³ *Private Company*, SECONDMARKET, *supra* note 95.

¹¹⁴ See *About Us*, SHARESPOST, <https://welcome.sharespost.com/about-us> (last visited Oct. 11, 2012) (stating SharesPost’s goals as making “the process of managing secondary liquidity and raising primary capital easier and more transparent”); see also, *e.g.*, Deborah L. Cohen, *Going Public, in Baby Steps, Using Secondary Markets*, REUTERS (Nov. 29, 2011), <http://www.reuters.com/article/2011/11/29/us-cohen-secondarymarkets-idUSTRE7ASiNV20111129> (discussing SharesPost’s completion of a primary transaction); Udayan Gupta, *SharesPost Helps Raise \$200 Million for TrueCar*, INSTITUTIONAL INVESTOR (Sept. 23, 2011), <http://www.institutionalinvestor.com/article.aspx?articleID=2904731> (detailing the same transaction).

¹¹⁵ Press Release, SharesPost, SharesPost Solidifies Position as Leading Marketplace for Private Equities (Mar. 21, 2011), *available for download at* <https://welcome.sharespost.com/news-and-events/media-center> (click “Next” as needed to reach press release date). The number of members appears to be growing over time. See Press Release, SharesPost, SharesPost’s “Market Cap Monday” Highlights Third-Party Research Reports on Leading Private Companies (Dec. 5, 2011), *available for download at* <https://welcome.sharespost.com/news-and-events/media-center?>

listing of over 150 companies.¹¹⁶ It initially structured itself as an online “passive bulletin board,” allowing members to post offers to buy or sell shares but without direct involvement or facilitation by SharesPost itself.¹¹⁷ Over time, though, its model has shifted toward a more active facilitation of secondary transactions—a move which spurred an SEC investigation into the company’s failure to register as a broker-dealer.¹¹⁸ SharesPost subsequently acquired a registered broker-dealer, registered as an alternative trading system, and settled the administrative proceeding with the SEC.¹¹⁹

Unlike SecondMarket, SharesPost does not work closely with private companies. Instead, it retains more of a marketplace-type approach between buyers and sellers. The secondary transaction process on SharesPost begins when a seller works with a SharesPost “transaction specialist” to post an indication of interest to sell.¹²⁰ If a buyer agrees to the terms of a seller’s posting, the buyer can use the SharesPost system to create a form of agreement for the transaction, which she then sends to the seller for electronic signature.¹²¹ The parties’ identities are not disclosed to each other

page=1 (click “Next” as needed to reach press release date) (claiming “more than 83,000 members”).

¹¹⁶ Press Release, SharesPost, SharesPost Becomes Registered Broker-Dealer and Alternative Trading System (Mar. 14, 2012), *available for download at* <https://welcome.sharespost.com/news-and-events/media-center> (click “Next” as needed to reach press release date).

¹¹⁷ Yarow, *supra* note 10. “Passive bulletin board” is a nontechnical term for SharesPost’s initial structure. In organizing that structure, the company appears to have relied on a series of SEC advisory and interpretive positions concerning registration as a broker-dealer and a national securities exchange. *Id.* For examples of these no-action letters, see Oil-N-Gas, Inc., SEC No-Action Letter, 2000 WL 1119244 (June 8, 2000), OilOre.com, SEC No-Action Letter, 2000 WL 546573 (Apr. 21, 2000), Angel Capital Electronic Network, SEC No-Action Letter, 1996 WL 636094 (Oct. 25, 1996), Real Goods Trading Corp., SEC No-Action Letter, 1996 WL 422670 (June 24, 1996), and Spring Street Brewing Co., SEC No-Action Letter, 1996 WL 899364 (Apr. 17, 1996).

¹¹⁸ See SharesPost, Inc., Exchange Act Release No. 66,594, 2012 WL 1029004, at *3-4 (SEC Mar. 14, 2012) (admin. order) (noting how SharesPost evolved from serving as a bulletin board for potential traders to an intermediary helping transactions move toward completion).

¹¹⁹ *Id.* at *5. The SEC imposed an \$80,000 sanction against SharesPost for violating Section 15(a) of the Exchange Act by effecting securities transactions for the accounts of others without registering as a broker-dealer. *Id.*; see also Press Release, SEC, SEC Announces Charges from Investigation of Secondary Market Trading of Private Company Shares (Mar. 14, 2012), <http://www.sec.gov/news/press/2012/2012-43.htm> [hereinafter SEC Press Release] (quoting Marc Fagel, Director of the SEC’s San Francisco Regional Office, as observing, “The newly emerging secondary marketplace for pre-IPO stock presents risk for even savvy investors Broker-dealer registration helps ensure those who effect securities transactions can be relied upon to understand and faithfully execute their obligations to customers and the markets. SharesPost skirted these important provisions”).

¹²⁰ *FAQ*, SHARESPOST, *supra* note 76.

¹²¹ *Id.*

until both parties have signed the agreement.¹²² However, either party, by clicking a button to send an e-mail, may request the other party's identity.¹²³ Once signed by both the buyer and seller, the agreement is considered binding.¹²⁴ The buyer can also start the same back-and-forth process with a "post to buy" instead of "post to sell."¹²⁵

SharesPost provides the fully executed agreement to the escrow agent, who assists the parties in navigating the issuer's transfer process and processes the transaction.¹²⁶ Restrictive agreements on the stock, such as rights of first refusal, can slow the transaction, but even in such circumstances closing often occurs within sixty days of providing formal notice to the company.¹²⁷

The minimum sales price for a transaction is \$25,000,¹²⁸ and the average trade is about \$200,000.¹²⁹ SharesPost charges a fee of three percent of the transaction or \$5000, whichever is greater, as a commission for its "transaction specialists," who facilitate the process.¹³⁰ The escrow agent charges a flat fee of \$1,500 to each party.¹³¹

As with SecondMarket, participation is a limited affair. Only SharesPost members with a password-protected account can participate.¹³² Registering as a member provides basic access to the site, and once a SharesPost broker

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ *Id.* In addition to this basic process for buying and selling, SharesPost also offers auctions for interests in single-purpose funds designed to buy a particular private company stock. *See* SharesPost, Inc., *supra* note 118, at *4 (detailing SharesPost's model whereby "buyers were bidding on interests in [a] fund and the fund would in turn purchase the stock").

¹²⁶ *FAQ*, SHARESPOST, *supra* note 76.

¹²⁷ *Id.* When private companies issue stock, certain transfer restrictions or agreements are often included, such as rights of first refusal, that can limit the transferability of the stock. *See* CONSTANCE E. BAGLEY & CRAIG E. DAUCHY, *THE ENTREPRENEUR'S GUIDE TO BUSINESS LAW* 101-02 (2d ed. 2003) (discussing the "right of first refusal" and "buy-sell agreements"); Stone, *supra* note 83 (describing how technology companies sometimes restrict the transferability of their stock); *see also* Jonathan Macey & Maureen O'Hara, *Stock Transfer Restrictions and Issuer Choice in Trading Venues*, 55 CASE W. RES. L. REV. 587, 606-09 (2005) (discussing the validity of share transfer restrictions).

¹²⁸ *FAQ*, SHARESPOST, *supra* note 76.

¹²⁹ Teitelbaum, *supra* note 12. In contrast, the average trade on SecondMarket is \$1-2 million. *Id.*

¹³⁰ *FAQ*, SHARESPOST, *supra* note 76.

¹³¹ *Id.*

¹³² *Id.*

has confirmed that the member is qualified to invest, the individual or entity can access additional information and purchase stock.¹³³

Unlike SecondMarket, SharesPost does disclose historical data, including previous transaction prices, on the site.¹³⁴ In addition, SharesPost has collaborated with third-party analysts and commentators in an effort to increase the information available to market participants trying to determine stock valuations.¹³⁵

II. POTENTIAL BENEFICIAL ROLE OF SECONDARY MARKETS FOR PRIVATE COMPANY STOCK

Despite their different approaches, the private secondary markets serve the same essential function: they make it easier and more efficient for buyers and sellers of private-company stock to find one another and transact. This intermediating or connecting function is powerful.

¹³³ See Evelyn M. Rusli, *As S.E.C. Watches, Secondary Market Seeks Transparency*, N.Y. TIMES DEALBOOK (Mar. 18, 2011, 2:59 PM), <http://dealbook.nytimes.com/2011/03/18/as-s-e-c-watches-secondary-market-seeks-transparency> ("Prospective clients must . . . pass a multistep qualification process to ensure that they meet the financial requirements, including a net worth of at least \$1 million or an annual salary of at least \$200,000 in the last two years."); Yarow, *supra* note 10 (quoting SharesPost CEO David Weir's discussion of the company's "multiple levels of security").

¹³⁴ See *Benefits of SharesPost for Individual Investors*, SHARESPOST, <https://welcome.sharespost.com/benefits-of-sharespost/for-investors/individual-investors> (last visited Oct. 11, 2012) (indicating that members can view "historical trade data"); see also *SharesPost Private Company Share Prices Now on Bloomberg*, BLOOMBERG (Nov. 9, 2011), <http://www.bloomberg.com/apps/news?pid=conewsstory&tkr=BPW:GR&sid=a950RzGleAgA> (announcing Bloomberg subscribers' access to SharesPost's "real-time pricing" for private companies and historical data, including prices paid and trending graphs).

¹³⁵ See *Third-Party Research on SharesPost*, SHARESPOST, <https://welcome.sharespost.com/features/sharespost-research> (last visited Oct. 11, 2012) [hereinafter *Third-Party Research*, SHARESPOST] (boasting "over 450 research reports from 11 third-party research providers"). The quantity of the third-party research provided by SharesPost appears to be growing steadily. See Rusli, *supra* note 133 (reporting 230 available research reports available as of March 2011). For a period of time, SharesPost provided an index tracking a small number of venture-backed private companies as a reference point for valuation. Brian Caulfield, *SharesPost Launches Index*, FORBES (Mar. 3, 2010, 11:00 AM), <http://www.forbes.com/sites/velocity/2010/03/03/sharespost-launches-index> (reporting SharesPost's launch of "what it says is the first index to track the performance of venture-backed private companies"); see also Jay Gould, *Buyer Beware: SharesPost Index Under Values LinkedIn by Billions*, SECOND SHARES (Mar. 30, 2010), <http://www.secondshares.com/2010/03/30/buyer-beware-sharespost-index-under-values-linkedin-by-billions> (criticizing the SharesPost Index and noting that "providing incomplete and insufficient data when determining valuations is unprofessional at best, and potentially very dangerous to these potential buyers on their exchange").

While shares in a private company have previously been transferable, notwithstanding certain contractual restrictions and the constraints of registration exemptions, in practice the market has been notably illiquid and ad hoc.¹³⁶ Finding a buyer or seller has been difficult. Imagine a potential investor decides she wants to invest in a particular private company stock. Without inside connections, she has no way to know whether any shareholders in that company are willing to sell or whether a seller may sell the stock within an available exemption from registration. These obstacles could prevent the transaction from occurring. SharesPost and SecondMarket provide centralized sites for buyers and sellers to overcome these obstacles and transact.

In addition to reducing search costs, the private secondary markets may also lower the parties' transaction costs in carrying out the trade. Before the rise of these platforms, it had been notoriously difficult for outsiders to value private company shares without extensive due diligence.¹³⁷ While the platforms charge fees for their services, they lower transaction costs by providing some, albeit limited, information for valuing stock. For its part, SecondMarket has started involving the issuer companies in their transaction process, which seems to have generally resulted in more disclosure.¹³⁸ SharesPost, on the other hand, provides information such as recent buy-sell bids, contract prices, and third-party research reports.¹³⁹ Both also provide form agreements, electronic signature functions, escrow services, and assistance in navigating any issuer restrictions on the stock.¹⁴⁰ These functions all serve to lower the cost of secondary transactions in private company stock.

Thus, the secondary markets make it easier and more efficient for buyers and sellers to identify each other and transact. Moreover, as the secondary markets lower search and transaction costs, the network may grow, and the

¹³⁶ See, e.g., Stone, *supra* note 83 (describing secondary transactions before the new markets as "carefully negotiated affairs," and quoting a Silicon Valley financier who stated they were "very occasional transactions . . . done the old-fashioned way . . . [by] earn[ing] the respect and trust of the company").

¹³⁷ Ibrahim, *supra* note 9, at 21-22.

¹³⁸ See *supra* notes 93-95, 105, and accompanying text.

¹³⁹ See *supra* 134-35 and accompanying text.

¹⁴⁰ FAQ, SHARESPOST, *supra* note 76; Private Company, SECONDMARKET, *supra* note 95; see also SAWYER ET AL., *supra* note 30, at 12 ("Most direct secondary transactions necessitate the waiving of rights or privileges by the company and existing investors, the executing of a stock transfer agreement with the company, and the adoption and adherence to existing operative documents by the new investor.").

liquidity of private company stock may increase.¹⁴¹ Although the market remains relatively illiquid, the increase in liquidity of private company stock may benefit stockholders as well as start-up companies.¹⁴²

As for liquidity benefits to stockholders, the secondary markets provide an exit option at the individual level, rather than at the company level as with an acquisition or IPO. This individual exit option is particularly important because “[t]he ability to control exit is crucial to the venture capitalist’s business model,”¹⁴³ and the venture capital industry has faced a declining IPO market and longer average time before a company is acquired or goes public.¹⁴⁴ Furthermore, employees in start-up companies have also faced difficulty with illiquidity, as few people want to wait ten years or more before being able to cash in on stock options awarded as incentive compensation.

Increased liquidity for stockholders may in turn create ex ante benefits for start-up companies. With more exit opportunities, investors may be less inclined to price an “illiquidity premium” into their potential investments.¹⁴⁵ This may lead to more start-ups receiving funding than might otherwise occur without the secondary markets.¹⁴⁶ “By offering a market price and exit transaction at any stage . . . the secondary market can help promote allocation to venture in the first place.”¹⁴⁷

¹⁴¹ It is worth underscoring that increased liquidity does not necessarily mean a great deal of liquidity. There were only 689 transactions of Facebook stock on SecondMarket between 2008 and early 2012, and it was one of the most heavily traded stocks on the site. Felix Salmon, *How to Make \$50 Million Trading Facebook Shares*, REUTERS (May 18, 2012), <http://blogs.reuters.com/felix-salmon/2012/05/18/how-to-make-250-million-trading-facebook-shares>. Moreover, tertiary trades are uncommon. See Felix Salmon, *How SecondMarket Works*, REUTERS (Apr. 12, 2011), <http://blogs.reuters.com/felix-salmon/2011/04/12/how-secondmarket-works> (reporting “maybe half a dozen instances” of tertiary trades).

¹⁴² See Ibrahim, *supra* note 9, at 21 (“The increased liquidity offered by the [secondary] market has both ex post benefits for individual investors looking to sell and ex ante benefits for nascent start-ups that need funding.”); see also Zohar Goshen & Gideon Parchomovsky, *On Insider Trading, Markets, and “Negative” Property Rights in Information*, 87 VA. L. REV. 1229, 1231 n.8 (2001) (“A securities market is liquid when investors can buy or sell shares on very short notice.” (citing JONATHAN R. MACEY, *INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY* 7 (1991))).

¹⁴³ Smith, *supra* note 20, at 316; see also *supra* Section I.A.

¹⁴⁴ The secondary markets could be particularly useful for “angel investors” who may tend to have more concentrated portfolios than VCs. See Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1424 (2008) (discussing research suggesting angel investors tend to be less diversified in investments than venture capitalists). “Angel investors are wealthy individuals who personally finance the same high-risk, high-growth start-ups as venture capitalists but at an earlier stage.” *Id.* at 1406.

¹⁴⁵ See Ibrahim, *supra* note 9, at 22-23 (explaining that venture capital investors demand a higher rate of return on illiquid investments, which in turns makes investment less likely).

¹⁴⁶ See *id.* at 23-24.

¹⁴⁷ BURSTEIN & SCHWERIN, *supra* note 30, at 8.

The secondary markets may provide additional benefits beyond increased liquidity. In the other scholarly article published to date on the secondary markets, Darian Ibrahim explored their beneficial role in the start-up and venture capital environment, specifically identifying improved corporate governance benefits as well as greater liquidity.¹⁴⁸ Ibrahim argues that entrepreneurs and VCs can use the threat of a secondary market exit to reduce each other's opportunistic conduct in the management of the firm.¹⁴⁹ Further, he argues that the secondary markets can mitigate conflicts between VCs and entrepreneurs over traditional exits.¹⁵⁰ That is, the secondary markets provide a "release valve" that allows the party seeking an early exit to sell her stake separately and avoid forcing the start-up as a whole into a suboptimal exit.¹⁵¹ These potential benefits come, however, with a host of concerns that the next Part explores.

III. INFORMATION ISSUES IN THE SECONDARY MARKETS FOR PRIVATE COMPANY STOCK

Regulators have begun to examine the secondary markets and to debate whether they should encourage these markets by loosening the legal strictures constraining their growth, or, conversely, whether they should

¹⁴⁸ See generally Ibrahim, *supra* note 9, at 24-27. See also Mendoza & Vermeulen, *supra* note 14, at 16 ("Without sufficiently clear options to exit from portfolio firms, it would be difficult to align the interests of the entrepreneurs and those who invest in a company during the different stages of its development.").

¹⁴⁹ Ibrahim, *supra* note 9, at 26; see also BURSTEIN & SCHWERIN, *supra* note 30, at 7 (observing that "investors and management teams are increasingly viewing the secondary market as a method to provide liquidity to help solve a wide range of issues, from employee motivation to litigation and severance situations").

¹⁵⁰ See Ibrahim, *supra* note 9, at 29 ("The party seeking the early exit can sell in the direct market . . ."); BURSTEIN & SCHWERIN, *supra* note 30, at 7-8 (noting that secondary markets may give venture capital firms greater ability to manage venture capital assets in a portfolio, such as by adjusting their risk and return in a fund, or achieving partial liquidity on some of their investments before a traditional exit for a portfolio company).

¹⁵¹ Ibrahim, *supra* note 9, at 29. This potential benefit may come with the corresponding concerns, however, that allowing employees to sell their stock lowers their incentives to exert effort in the company, and that allowing VCs to exit may lead to less vigorous monitoring. See Stone, *supra* note 83 ("Now some founders and employees are motivated to leave before the IPO because they are free to cash out . . ."); cf. Letter from Mary L. Schapiro, Chairman, SEC, to Darrell E. Issa, Chairman, House Comm. on Oversight and Gov't Reform 24 (Apr. 6, 2011), available at <http://www.sec.gov/news/press/schapiro-issa-letter-040611.pdf> [hereinafter Schapiro] (noting that outside investors cannot monitor private companies like public companies because of limited disclosure and that VCs are by contrast "value-added investors").

regulate these marketplaces more strictly.¹⁵² The potential benefits discussed in Part II suggest that the secondary markets should be encouraged, because they increase liquidity and may foster the venture capital cycle, which contributes to innovation and economic growth.¹⁵³

But to focus only on the markets' potential benefits leaves significant issues unexplored. Specifically, concern has been rising about the lack of information and the information asymmetry between buyers and sellers in the secondary markets. This apprehension relates to both the quality and amount of information being disclosed.¹⁵⁴ Underlying these concerns is the larger worry that without an adequate amount of accurate information, private company stock cannot be properly valued.¹⁵⁵ Furthermore, the concern about asymmetric information raises questions about the related issue of insider trading.

Imperfect or asymmetric information is, of course, a common issue in contracting.¹⁵⁶ In some cases the law intervenes, and in some it does not. Public securities laws provide an example of regulatory intervention. In many contexts, though, parties can address information issues on their own through contract, or they can agree to a price that reflects the uncertainty surrounding their contract.¹⁵⁷ Thus, the decision of whether to regulate

¹⁵² See Schapiro, *supra* note 151, at 21-22 ("Trading that develops on online trading platforms . . . can provide much desired liquidity to investors, which can assist in attracting investors to smaller private companies. This benefit, however, must be balanced with investor protection concerns . . .").

¹⁵³ See Ibrahim, *supra* note 9, at 36, 47 (noting that the markets "must continue to develop for their benefits to be fully realized" and that "[g]iven the surplus that entrepreneurial activity produces for society, VC secondary markets should be . . . encouraged by policymakers").

¹⁵⁴ See Schapiro, *supra* note 151, at 22 (discussing the "lack of information available to investors").

¹⁵⁵ For a discussion of why inaccurate stock prices may be undesirable in the public securities context, see Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977 (1992). But see Jeff Schwartz, *Fairness, Utility, and Market Risk*, 89 OR. L. REV. 175, 186-89 (2010) (arguing that share-price accuracy as a theory of regulation lacks an "intellectual core").

¹⁵⁶ For classic literature in economics and contract theory on imperfect information and information asymmetry, see generally George A. Akerlof, *The Market for "Lemons": Qualitative Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970); Michael Rothschild & Joseph Stiglitz, *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, 90 Q.J. ECON. 629 (1976); Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630 (1979); and Michael Spence, *Job Market Signaling*, 87 Q.J. ECON. 355 (1973).

¹⁵⁷ See, e.g., Gilson, *supra* note 15, at 1076 ("All financial contracts respond to three central problems: uncertainty, information asymmetry, and opportunism in the form of agency costs."); Robert E. Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 CALIF. L. REV. 2005, 2007 (1987) ("Parties enter into continuing contractual relationships in order to exploit the economic benefits of long-term planning and coordination. Even so, contingencies may later materialize and

requires an analysis of the information issues that exist in the private secondary markets and a determination whether the markets and parties are equipped to respond well to these issues without regulatory intervention.

To that end, this Part first examines the issues of lack of information, asymmetric information, and conflicts of interest, and then turns to insider trading.

A. Lack of Information, Asymmetric Information, and Conflicts of Interest

The starting point for the information issues in the private secondary markets is that, by nature, generally less information is publicly available about private companies than public ones because private companies do not have public disclosure obligations.¹⁵⁸ Private companies are often hesitant to disclose information, and for good reason—their competitors can benefit by knowing their business plans and financial information.¹⁵⁹ It is accordingly common for employees, consultants, and stockholders of private companies to be bound by confidentiality agreements as a condition of employment or share purchase. Further, many private companies are keen to avoid the greater scrutiny to which regulators and shareholders often subject public companies.

In addition, the transactions on these marketplaces are secondary—meaning that the company itself is not a party to the transaction and the seller is an existing shareholder. The company is not, as a general matter, obligated to disclose information to facilitate secondary transactions. The seller may not have significant information about the company, or may have signed a confidentiality agreement with the company and therefore may not be at liberty to disclose it. The Rule 144 exemption for resale of restricted stock does not impose an information disclosure requirement on non-affiliate sellers.¹⁶⁰

As a result, unless the company or seller voluntarily discloses information or it is otherwise available—such as in a third-party analyst report or publicly available information—the buyer may possess little information

frustrate the parties' efforts to realize these shared objectives. Anticipating this, contracting parties must distribute between themselves the risks of their enterprise.”).

¹⁵⁸ This Article focuses on information about U.S. private companies. Note that there are substantial differences in how other countries regulate disclosure by private companies. *See, e.g.,* Benito Arruñada, *Mandatory Accounting Disclosure by Small Private Companies* 32 EUR. J.L. & ECON. 377, 378 (2011) (providing an overview of European Union practices, which require all private companies to register with a public registry).

¹⁵⁹ *See* SAWYER ET AL., *supra* note 30, at 25.

¹⁶⁰ *See supra* note 58 and accompanying text.

when deciding whether to purchase stock at the offered price. The buyer faces the risk that the stock will be valued at a lower price when the company eventually discloses information.

The amount and quality of publicly available information about private companies varies widely. Some companies are relatively early-stage or have not attracted much attention, and consequently very little information about them is available. By contrast, a fairly substantial amount of information may be available about mature, private companies in the public eye. Examples of such information include the company's certificate of incorporation, which is a public document, and press releases regarding products, customers, or strategic partners.¹⁶¹

Potential buyers might give weight to the reputation value of other known investors in a private company, such as well-respected venture capital firms. However, without a capitalization table or financing documents, it is difficult to know how large a stake an investor has in the company, at what stage it invested, and whether the investor has since sold part of its position.

Some private companies are the subject of reporting on sites such as Second Shares and TechCrunch or more general media such as the *Wall Street Journal* and the *New York Times*.¹⁶² Deal term data may even be available in databases such as VC Experts.¹⁶³

The Internet, meanwhile, can also be a source of information, but that information can be strategically disclosed or unreliable.¹⁶⁴ For instance, when Bloomberg recently cited Twitter insiders as the source of sales projections for the distant future, other commentators speculated that they might have released this information for public relations purposes or to "boost the reputation of Twitter to move some stock on private markets like

¹⁶¹ See SAWYER ET AL., *supra* note 30, at 19.

¹⁶² See generally *About*, SECOND SHARES, <http://www.secondshares.com/about> (last visited Oct. 11, 2012); *About TechCrunch*, TECHCRUNCH, <http://www.techcrunch.com/about> (last visited Oct. 11, 2012). See also, e.g., Amir Efrati & Spencer E. Ante, *Twitter Seeks \$7 Billion Valuation*, WALL ST. J., July 6, 2011, at B1 (reporting on the financing of Twitter, a private company); Thomas Kaplan, *Facebook Announces 5-for-1 Stock Split*, N.Y. TIMES DEALBOOK (Oct. 1, 2010, 3:37 PM), <http://dealbook.nytimes.com/2010/10/01/facebook-announces-5-to-1-stock-split> (providing coverage of the financial maneuverings of Facebook when it was a private company).

¹⁶³ See *About Us*, VC EXPERTS, <https://www.vcexperts.com/vce/about-us> (last visited Oct. 11, 2012) ("VC Experts provides specialized content on private equity & venture capital fundraising, valuations and deal term details on thousands of privately funded companies . . .").

¹⁶⁴ Cf. Troy A. Paredes, *Blinded By The Light: Information Overload And Its Consequences For Securities Regulation*, 81 WASH. U. L.Q. 417, 475 & n.266 (2003) (noting that "the presentation of information . . . can be manipulated, for better or worse" and discussing the Internet as a source of information).

SharesPost and SecondMarket.”¹⁶⁵ Moreover, one simply cannot find on the web all of the information that is typically considered key to properly valuing private company stock, including the “[r]ecent company capitalization table[, c]orporate documents (charter, bylaws, and investment agreements)[, h]istorical and projected financials of the company[, and] recent board presentations and/or minutes.”¹⁶⁶ One secondary market investor explained he made investment decisions “going by gut,” which he described as saying to himself, “I like the product. I think the company’s doing well. The news that I read on TechCrunch or AllThingsD[igital] or any one of these technology blogs, it all looks good.”¹⁶⁷ This investor noted that when electric car manufacturer Tesla went public he discovered that the company whose stock he had purchased had been losing money.¹⁶⁸ He commented, “If I had actually known what the financials looked like, I would not have invested in Tesla.”¹⁶⁹

Third-party information, such as the research reports available on SharesPost,¹⁷⁰ likewise varies in quality and amount. SharesPost offers over 450 research reports from eleven third-party research providers.¹⁷¹ While this third-party research adds to the information available about a company’s stock, it is not a prospectus.¹⁷² Without comprehensive information from the company itself, third-party researchers likely have trouble providing robust valuation estimates. Furthermore, third-party researchers with undisclosed conflicts of interest might mislead potential market participants, a point discussed in more detail below.

¹⁶⁵ Erik Sherman, *Is Twitter Leaking to the Media to Primp for IPO?*, CBS NEWS (June 4, 2012, 5:14 PM), http://www.cbsnews.com/8301-505124_162-57446882/is-twitter-leaking-to-the-media-to-primp-for-ipo.

¹⁶⁶ SAWYER ET AL., *supra* note 30, at 17.

¹⁶⁷ Ilya Marritz, *Hunting for Hot Stocks, Some Investors Head to Private Markets*, WNYC NEWS (Apr. 30, 2012), <http://www.wnyc.org/articles/wnyc-news/2012/apr/30/hunting-hot-stocks-some-investors-head-private-markets> (alteration in original).

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

¹⁷⁰ See *supra* notes 134-35 and accompanying text.

¹⁷¹ See *Third-Party Research*, SHARESPOST, *supra* note 135 (listing available research reports).

¹⁷² SharesPost subsidizes some of the research. See *Third-Party Research*, SHARESPOST, *supra* note 135 (“SharesPost is not the author of these reports but rather is only distributing research from a variety of independent sources. In some cases, SharesPost subsidizes the research presented on its platform.”).

In addition to providing third-party reports, SharesPost provides pricing data about contracts that have been executed through its site,¹⁷³ which increases transparency in the market to a degree. Indeed, SharesPost adopted this policy of posting trading histories, and having its brokers review price postings before they go live on the website, after significant efficiency flaws came to light.¹⁷⁴ In January 2011, for example, some investors agreed to trade then-private Facebook stock for \$60 a share, more than twice the price other investors paid that day.¹⁷⁵ Efficiency flaws of this type may persist, however, particularly since SecondMarket does not post such trading history and the prices on the two markets may not always be the same.¹⁷⁶

More importantly, the trading history information, if available, may be of limited value if the other offers and transactions were also made without the information necessary to accurately price the stock. That is, the information SharesPost discloses about offers and contracts may inform potential participants about market activity, but these transactions may not bear much relation to the company fundamentals if critical information is not available. Market participants who buy and sell stock without knowledge of underlying fundamentals may propagate stock mispricing.¹⁷⁷

Thus, the bottom line is that market participants may have little to no information of the type typically considered necessary for accurate pricing. Varying amounts of other information may be available, but it may be inaccurate and misleading. Further, it would seem that investors cannot rely

¹⁷³ Davidoff, *supra* note 93; *SharesPost Media FAQ: 2012*, SHARESPOST, <https://welcome.sharespost.com> (click “News and Events,” then click “Media Center,” then click “Download” under “SharesPost Media FAQ”) (last visited Oct. 11, 2012).

¹⁷⁴ See Teitelbaum, *supra* note 12 (calling trades of private company stock based on minimal data a “leap of faith”).

¹⁷⁵ *Id.*

¹⁷⁶ See *id.* (contrasting SecondMarket’s practice of non-posting with SharesPost’s); see also Pui-Wing Tam & Geoffrey A. Fowler, *Hot Trade in Private Shares of Facebook*, WALL ST. J., Dec. 28, 2010, at A1 (noting that in December 2010, the average valuation of Facebook based on SharesPost transactions had risen about 25%, while Facebook’s valuation based on SecondMarket transactions had risen only about 12%).

¹⁷⁷ A variety of market participants have made this observation. See, e.g., Bo Brustkern, Response to *Are Secondary Markets Helping to Overvalue Private Companies?*, QUORA (Dec. 18, 2010), <http://www.quora.com/Are-secondary-markets-helping-to-overvalue-private-companies> (“As a valuation expert, I believe that the majority of transactions taking place in today’s secondary markets are *not* reflective of Fair Value . . . I would say that a majority—if not an absolute union—of my peers [who attended a Fair Value Forum meeting] are in agreement with me on that.”).

on efficiencies of the market for protection because stocks in these markets can be thinly traded and trades are not immediate.¹⁷⁸

Adding to the concern about the sufficiency of information is the issue of asymmetric information between buyers and sellers. Specifically, the concern is that investors and business insiders who have had access to information about the finances and direction of the company constitute one side of the market, while individual and institutional investors who do not have such access or knowledge constitute the other side.¹⁷⁹

The concern stems from the notion that in the world of venture capital-backed companies, nearly every early investor and employee has access to inside information. That changes as the company grows, and there are certainly exceptions, but on the whole it is an aspect of the culture and economic dynamic of start-ups, particularly in Silicon Valley's technology sector. VCs are known for providing "smart money"—they are not passive investors, but rather knowledgeable, savvy investors that actively try to help the company grow, with large investors often taking a seat on the board.¹⁸⁰

Meanwhile, buyers in secondary markets can be anyone meeting the accredited-investor or QIB standard.¹⁸¹ Hence, asymmetries can arise in many ways. A buyer might be a venture capital firm trying to increase its position, and the seller could be a former employee who was not, or is no longer, privy to company information. Or, perhaps more likely, the asymmetry could arise because the seller is someone with experience at the company, such as a current or former employee, and the buyer is an individual or institution with no such connection. Plus, the asymmetry is not always detectable. The buyer may not know the identity of the seller until after signing the purchase agreement.¹⁸²

A particular concern regarding asymmetric information is where a conflict of interest exists. SEC Chairman Mary Schapiro recently acknowledged this concern, stating, "In the absence of an informed market,

¹⁷⁸ Cf. Troy A. Paredes, *On the Decision to Regulate Hedge Funds: The SEC's Regulatory Philosophy, Style, and Mission*, 2006 U. ILL. L. REV. 975, 1001 ("[T]he reasonable expectations investors have that they can rely on securities prices as approximating fundamental value is a cornerstone of securities market integrity.").

¹⁷⁹ For a discussion of problems arising from informational asymmetries, see Stephen J. Choi, *A Framework for the Regulation of Securities Market Intermediaries*, 1 BERKELEY BUS. L.J. 45 (2004).

¹⁸⁰ See, e.g., Gilson, *supra* note 15, at 1070-76 (providing an overview of the structure of American venture capital); Thomas F. Hellmann, *Venture Capitalists: The Coaches of Silicon Valley*, in *THE SILICON VALLEY EDGE* 276, 276 (Chong-Moon Lee et al. eds., 2000) (explaining the role that venture capitalists play in the development of start-up companies).

¹⁸¹ See *supra* notes 52 & 78 and accompanying text.

¹⁸² See *supra* notes 122-23 and accompanying text.

concerns can be raised that pricing of securities may be influenced by conflicted market participants who may be buying and selling for their own account as well as facilitating transactions for other buyers and sellers.”¹⁸³ Because conflicts may go undisclosed, it is difficult to gauge the extent to which conflicted participants pervade the secondary markets.

However, the media has reported on at least a handful of examples of conflicts of interest. Last year, Global Silicon Valley Partners posted a research note about then-private Facebook stock, valuing it at a significantly lower price than the price at which its affiliate concurrently bought it.¹⁸⁴ Another example includes investment firm GreenCrest Capital, which provides a research service that compiles financial reports on popular start-ups, while also offering single-company and blended funds of stock in the same private companies.¹⁸⁵ The research service is “led by a team of former analysts at Wall Street firms [who] draw from publicly available information and interviews with the company’s investors, employees and industry experts.”¹⁸⁶ GreenCrest takes only institutional investors as clients, and has pointed to that approach as mitigating the conflict of interest. “There is a conflict of interest to some extent—we do seek to do business with the companies we cover. However, our investors will keep that in mind before they make their investment decisions.”¹⁸⁷

Finally, tales of conflicts of interest abound in Silicon Valley, the geographic home of many of the start-up companies whose stock is traded on secondary markets. Legendary venture capitalist John Doerr of Kleiner Perkins is rumored to have once said “no conflict, no interest” in describing

¹⁸³ Schapiro, *supra* note 151, at 22. Earlier this year, the SEC filed charges against two managers of private company stock funds and their firms for engaging in improper self-dealing by charging investors undisclosed fees. See SEC Press Release, *supra* note 119 (announcing the charges); Sarah N. Lynch & Aruna Viswanatha, *SEC Charges SharesPost, Felix Over Pre-IPO Trading*, REUTERS (Mar. 14, 2012, 7:25 PM), <http://www.reuters.com/article/2012/03/14/us-sec-sharespostidUSBRE82D1B420120314> (discussing the SEC’s suits against Felix Investments and its manager, which is pending, and the SEC’s charges against EB Financial Group and its manager, which settled).

¹⁸⁴ Davidoff, *supra* note 93. Global Silicon Valley Partners, a research provider for private company valuation, published a research note with a valuation of Facebook around \$52 billion while an affiliate purchased shares of the company at a valuation around \$68 billion. *Id.* The affiliate later explained that the research provider is now defunct and the research was in fact outsourced and independently produced, and there was not an economic relationship between the research producer and the affiliate that bought the stock. *Id.* However, this explanation does not assuage the concern that an affiliate might pay or otherwise encourage research reports to suggest valuations that would put the affiliate in an advantageous position for buying or selling.

¹⁸⁵ See Rusli, *supra* note 133.

¹⁸⁶ *Id.*

¹⁸⁷ *Id.*

his investment views.¹⁸⁸ While such a statement may have been only rumor, Silicon Valley is a small world for some investors. Doerr sits on the board of Google, which is said to have made a “soft bid” to acquire Twitter in 2010.¹⁸⁹ In late 2010, Kleiner Perkins invested \$150 million in Twitter.¹⁹⁰ Several months later, Doerr “raised eyebrows” with his participation in a Twitter board meeting as an “observer.”¹⁹¹ Around the time of its Twitter investment, Kleiner Perkins also reportedly invested in Groupon, another company that Google tried to acquire, and in Facebook, an emerging competitor to Google.¹⁹²

Perhaps responding to the perceived information problems, as noted in subsection I.B.1, SecondMarket has recently changed its model to require company approval for secondary transactions.¹⁹³ In doing so, it has generally required that companies provide two years of financials as well as other information.¹⁹⁴ One reason a company might agree to such disclosure is to exert some influence over the selection of secondary buyers. The company may not otherwise have specific rights to control the stock sale process, and managing “to whom and how the information is shared” allows the company to exert some influence.¹⁹⁵ The company may not be concerned about the identity of the investor if the stake is small, but it may be a more significant consideration if the secondary buyer will acquire a significant voting position.¹⁹⁶ Companies may wish to avoid having competitors become

¹⁸⁸ Henry Blodget, *No Conflict, No Interest: John Doerr, Twitter, and the Rise of Secondary Private Markets*, BUS. INSIDER (Mar. 11, 2011), http://articles.businessinsider.com/2011-03-11/tech/30001236_1_twitter-twitter-board-investment.

¹⁸⁹ *Id.*

¹⁹⁰ *Id.*

¹⁹¹ *Id.* Investors in venture capital-backed companies sometimes receive board “observation rights,” which give them the ability to sit in on board meetings and thereby get information about the company’s direction. Observation rights may exclude the observer from full participation in the board meeting, such as during the executive sessions. *See id.* (contextualizing Doerr’s role as a “board observer” at the Twitter board meetings); *see also* David Snow, *Disparity Meets Liquidity*, PRIVCAP (Mar. 22, 2011), <http://www.privcap.com/snowsnotes/2011/03/disparity-meets-liquidity> (explaining that “[e]ven investors who have no board or executive role at the corporate level are often given board ‘observations rights,’ meaning the ability to sit in on board meetings”).

¹⁹² *See* Blodget, *supra* note 188 (noting that Kleiner Perkins invested in companies that are potential partners or competitors of Google, where Doerr sits on the board of directors).

¹⁹³ Davidoff, *supra* note 93.

¹⁹⁴ *Id.*

¹⁹⁵ SAWYER ET AL., *supra* note 30, at 30.

¹⁹⁶ *See id.* (explaining that the identity of secondary investors “should be an important consideration if the secondary buyer will have a meaningful voting position amongst the shareholders or if they will play [a] role as a board member or observer”).

stockholders and to require that potential buyers sign a confidentiality or nondisclosure agreement with the company.¹⁹⁷

Companies may also be willing to disclose information for other reasons. They may have concerns about the accuracy of the pricing or about securing the best pricing for their stock.¹⁹⁸ They may want to support private trading to provide some liquidity to shareholders or employees, or to manage their total number of shareholders so as to avoid triggering the Section 12(g) threshold that would require the company to go public.¹⁹⁹ Finally, companies may wish to establish an insider trading policy and open limited trading windows with information disclosure, a point discussed in more detail below.

However, companies may not want to disclose all of the information that SecondMarket recommends. As discussed at the outset of this Section, many private companies want to avoid disclosing information that would benefit their competitors, and they generally want to avoid greater scrutiny. Companies may still have other reasons for not wanting to facilitate trading in their stock, including concerns about liability and employee retention.²⁰⁰

¹⁹⁷ See *id.* at 25 (“Once a potential buyer has indicated a sufficient level of interest in the transaction, they will be willing to sign a confidentiality agreement with the company, at which point the company can share a more substantial amount of information.”). The company may also insist that the buyer sign and acknowledge that the information was provided “as a convenience” and have the selling stockholder “indemnify the company from any claim arising from the accuracy or incompleteness of the information provided.” *Id.* at 26.

¹⁹⁸ See SAWYER ET AL., *supra* note 30, at 25 (describing the reservations that companies have about disclosing information to the secondary investor markets).

¹⁹⁹ See *supra* notes 64-74 and accompanying text. For example, by working with SecondMarket a company could arrange for multiple shareholders to sell to one buyer, thereby reducing the total number of shareholders of record.

²⁰⁰ Companies may view the secondary markets as having “created a legal quagmire that must be navigated.” Stone, *supra* note 83. Companies may be concerned about employee effort and retention. *Cf. supra* note 32. In addition, companies may be concerned about losing control over the shareholder base, inadvertently exceeding the record-holder threshold for going public, and valuation concerns regarding incentive compensation and an IPO. *Today's Marketplace for Securities of Pre-Public Companies and How We Got Here*, CORP. COUNS., Mar.-Apr. 2011, at 1, 3-4, available at <https://www.secondmarket.com/discover/wp-content/uploads/2012/01/Corporate-Counsel-Todays-Marketplace-for-Securities-of-Pre-Public-Companies.pdf>. And, although not a party to the secondary transaction, a company might be concerned about liability related to information it provides in connection with that process. Compliance with a registration exemption does not preclude liability under anti-fraud provisions of the securities laws, such as Rule 10b-5 governing omissions or misstatements. See SAWYER ET AL., *supra* note 30, at 26 (noting that the “law is ambiguous as to whether the provision of information creates what is called a Rule 10b-5 liability obligation from the company to the purchaser” and discussing best practices for a company to avoid liability); J.J. Colao, ‘An Abomination That Should Stop’: What’s the Problem with Secondary Markets?, FORBES (June 29, 2012, 8:58 AM), <http://www.forbes.com/sites/jjcolao/2012/06/29/an-abomination-that-should-stop-whats-the-problem-with-secondary-markets> (noting the concern

Given that SecondMarket makes money by charging fees for the transactions it facilitates, one might expect that its interests would sometimes diverge from requiring what would otherwise be optimal levels of information to those contemplating a trade. Reports suggested that SecondMarket did not require information disclosures from Facebook for secondary trading of its private shares.²⁰¹ Facebook was the most actively traded stock on SecondMarket before Facebook went public, and the source of a significant portion of SecondMarket's revenue.²⁰² Hence, SecondMarket's move to a model of working with companies to develop liquidity programs that include some information disclosure suggests that the market is responding to the problem—but the response may be insufficient. It is unclear whether all companies “listed” on SecondMarket have disclosed information and whether disclosures are of the type and amount that suffice to address the information concerns. Furthermore, it seems the information released to potential buyers is not standardized and so the company's disclosures may be limited and selective.

As we have seen, SharesPost does not require company involvement at all, apart from clearing any contractual restrictions on the stock. Its adaptations have been to provide historical trading data and third-party research reports. Consequently, while the private secondary markets have made some effort to promote information disclosure, they still raise concerns about the adequacy of the information available.

Among participants, the markets have started to get the reputation of facilitating transactions “executed more on public perception rather than investing fundamentals.”²⁰³ Thus, despite the potential for private ordering to address the information issues in these markets, such an approach may be failing.²⁰⁴

that companies whose stock is traded in secondary markets may face lawsuits); Memorandum from Goodwin Procter LLP to Annemarie Tierney, Gen. Counsel, SecondMarket Holdings, Inc. 3 (Mar. 16, 2012) [hereinafter Goodwin Procter Memo], *available at* <https://www.secondmarket.com/discover/wp-content/uploads/2012/01/Memo-on-Secondary-Sale-Disclosure-Requirements-Goodwin-Proctor.pdf> (discussing Rule 10b-5 and noting there is no anti-fraud safe harbor).

²⁰¹ See Davidoff, *supra* note 93; *supra* text accompanying note 103.

²⁰² See Spears, *supra* note 89 (reporting on the fees that Facebook trading brought to SecondMarket before going public).

²⁰³ SAWYER ET AL., *supra* note 30, at 10-11.

²⁰⁴ While it is difficult, if not dangerous, to draw conclusions from a single case, the Facebook IPO may suggest flawed price discovery in the secondary markets. In the weeks after its May 2012 IPO, Facebook stock fell to a price which had not been seen on private secondary markets since 2010. *Compare Facebook on SecondMarket*, SECONDMARKET, <https://www.secondmarket.com/facebook-on-secondmarket> (last visited Oct. 11, 2012) (providing a history of Facebook share prices on SecondMarket), *with* Alexei Oreskovic, *Facebook Shares Dive as Deadline for Insider Sales Nears*, REUTERS (Aug. 2, 2012, 6:08 PM), <http://www.reuters.com/article/2012/08/02/us-facebook->

B. *Insider Trading*

In addition to the broader issue of information asymmetry between buyers and sellers, a more specific concern exists about insider trading in these new markets.²⁰⁵ Before the rise of these marketplaces, privately negotiated secondary transactions were possible but more difficult and costly to arrange.²⁰⁶ Buyers and sellers had to find each other without a central marketplace. Parties shared their identities, and the transactions were often heavily negotiated after extensive due diligence by the buyer for the purposes of valuing the stock and reducing information asymmetry and the opportunity for insider trading. Now, the online marketplaces provide the possibility of anonymity between the buyer and seller before the agreement is signed and a process which does less to reduce information asymmetry. This Section explores the concerns about insider trading in the private secondary markets.

As a starting point, insider trading prohibitions are phrased broadly, applying to both public and private securities. Specifically, Rule 10b-5, promulgated under section 10(b) of the Exchange Act, provides that its fraud prohibitions apply “in connection with the purchase or sale of *any* security.”²⁰⁷

Rule 10b-5 has developed into the SEC’s principal legal source for insider trading liability.²⁰⁸ Congress has not clearly defined insider trading, but the core notion developed through case law is that insider trading occurs when someone buys or sells securities on the basis of material nonpublic information in breach of a fiduciary duty or a relationship of trust or confidence.²⁰⁹ Such trading constitutes a “deceptive device” under section 10(b)

shares-idUSBRE8711AS20120802 (reporting that the Facebook public share price dropped below \$20).

It would be imprudent to draw conclusions from this one example, however, because many factors contributed to the Facebook IPO and its subsequent pricing. With time, there will be more data to study the relationship between trading on private secondary markets and IPO pricing or pricing on a public market.

²⁰⁵ For a discussion of the rationale for distinguishing insider trading from unobjectionable trading on informational advantages, see generally Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 329-33 (1979).

²⁰⁶ See Stone, *supra* note 83, and accompanying text.

²⁰⁷ 17 C.F.R. § 240.10b-5 (2012) (emphasis added).

²⁰⁸ See RALPH C. FERRARA ET AL., FERRARA ON INSIDER TRADING AND THE WALL § 3.01 (2011).

²⁰⁹ See generally Robert A. Prentice, *Permanently Reviving the Temporary Insider*, 36 J. CORP. L. 343, 345-53 (2011) (noting that Congress and the SEC have not promulgated a definition of insider trading and discussing the history of insider trading law). Materiality is a fact-specific

and Rule 10b-5. Under current insider trading law, liability can arise in a few distinct ways.²¹⁰ Under the “classical theory,” an insider is required to disclose her material nonpublic information before trading, or abstain from trading, if she owes a fiduciary duty to her trading partner.²¹¹ A “tippee” can be held liable in the same way if her “tipper” has such a duty.²¹² Under the “misappropriation theory,” a trader is subject to Rule 10b-5 liability when she misappropriates material nonpublic information in breach of a fiduciary duty to the source of the information.²¹³

Notably, the key insider trading cases have developed in the context of trading public company stock.²¹⁴ Although the language of Rule 10b-5 includes private company stock, insider trading actions against private securities traders have been nearly nonexistent to date.²¹⁵ That may be because historically there has not been an active market for trading private company securities. And while liability is theoretically possible, given the broad phrasing of Rule 10b-5, the concept of insider trading is a somewhat problematic fit in the context of secondary transactions in private company shares.

inquiry which looks at whether there is “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1318 (2011) (citing *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988)). For a discussion of how courts and the SEC have often ignored or disregarded fiduciary principles in insider trading cases despite the Supreme Court’s dictates, see generally Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1336-64 (2009).

²¹⁰ In addition to the bases for liability discussed here, Rule 14e-3 prohibits traders from buying or selling securities using inside information related to a tender offer. 17 C.F.R. § 240.14e-3 (2012).

²¹¹ *Chiarella v. United States*, 445 U.S. 222, 228 (1980).

²¹² See *Dirks v. SEC*, 463 U.S. 646, 660 (1983) (“[A] tippee assumes a fiduciary duty . . . not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.”).

²¹³ See *United States v. O’Hagan*, 521 U.S. 642, 647 (1997); see also *id.* at 658 (“The misappropriation theory comports with § 10(b)’s language, which requires deception ‘in connection with the purchase or sale of any security,’ not deception of an identifiable purchaser or seller.”).

²¹⁴ See *supra* notes 211-13.

²¹⁵ One rare example includes a recent SEC enforcement proceeding involving a private company’s repurchasing of shares from employees at prices that did not reflect undisclosed higher third-party valuations and acquisition offers. See WINSTON & STRAWN, SEC RENEWS FOCUS ON INSIDER TRADING IN PRIVATE COMPANY STOCK (2011), available at [http://www.winston.com/sitefiles/publications/SEC_Briefing_12_20_11%20\(2\).pdf](http://www.winston.com/sitefiles/publications/SEC_Briefing_12_20_11%20(2).pdf) (discussing *SEC v. Stiefel Labs. Inc.*, No. 11-24438 (S.D. Fla. filed Dec. 12, 2011)).

For example, at the first level, there is a question of what information is actually public about a private company. As noted in Section III.A, private companies are not subject to mandatory disclosure rules like public companies. There is therefore not a base level of publicly available information about private companies, and they do not file periodic reports to update information. Indeed, there may be very little publicly available information about a private company, and much of the company's finances and other material information may be nonpublic.

Another challenge is that the proportion of shareholders with access to material nonpublic information is likely significantly greater in the private company context than the public one. Existing shareholders in venture-backed private companies have typically become shareholders by being founders who helped establish the business, investors who acquired shares in a round of venture financing involving due diligence, or employees, former employees, or consultants awarded stock options as incentive compensation for their work for the company.²¹⁶ All of these categories of shareholders might have inside knowledge about the company that may be material with regard to stock valuation. Furthermore, existing shareholders may be subject to company confidentiality agreements that reflect the private company's desire to keep information private.

Together, these differences suggest that a significant number of participants in the secondary markets may have material nonpublic information along with a corresponding duty to the company not to disclose that information. As a result, insider trading may be prevalent or difficult to avoid in secondary markets. The lack of public information about these companies and the proportion of people with access to material nonpublic information also raise the question of whether such holders can still buy or sell in a secondary transaction without violating insider trading laws. And without the participation of these shareholders, the secondary markets may be significantly constrained and fail to fully realize the benefits discussed in Part II.

There are limited ways that insider participants might avoid or minimize insider trading, apart from simply abstaining from trading. One possibility would be for a company to agree to disclose all material information to the potential buyer—or at least all the material information that the existing shareholder has, on an ad hoc basis. For instance, SecondMarket itself has recently arranged a share tender for its own stock, which it

²¹⁶ See Russolillo, *supra* note 91 (noting that, on SecondMarket, nearly eighty percent of sellers in the past year were ex-employees and eleven percent of sellers were current employees).

stated is the first of many liquidity events the company plans to arrange for its shareholders.²¹⁷ In arranging such a liquidity event, the company can eliminate information disparities between buyers and sellers by allowing the sellers to share any material nonpublic information in their possession, and the company can require buyers to sign confidentiality agreements.

Another possibility would be for a company to move to a more formal public company-style compliance program. While for many years a myth existed in Silicon Valley that insider trading rules did not apply to private company stocks,²¹⁸ that understanding has been changing with the rise of secondary marketplaces and some private companies have started adopting insider trading policies.²¹⁹ An insider trading policy could provide for trading windows with disclosures, as well as black-out periods, such as when the company is fundraising, executing or discussing material transactions, or around the end of the fiscal quarter or year.²²⁰ The company might also refrain from granting “observation rights,” which give an investor the ability to sit in on board meetings.²²¹

²¹⁷ See Lizette Chapman, *SecondMarket Shareholders Cash Out at \$160M Valuation in Secondary Deal*, DOW JONES PRIVATE EQUITY & VENTURE CAPITAL (Sept. 28, 2011), <http://pevc.dowjones.com/Article?an=DJFPEA0020110928e79s0002t> (reporting that SecondMarket allowed its shareholders to sell \$13 million worth of shares based on a company valuation of \$160 million).

²¹⁸ See, e.g., John Carney, *Does Silicon Valley Have an Insider Trading Problem?*, CNBC (Apr. 1, 2011, 1:10 PM ET), http://www.cnbc.com/id/42377452/Does_Silicon_Valley_Have_an_Insider_Trading_Problem (“Many in Silicon Valley apparently believe that insider trading rules don’t apply to buying or selling stakes in non-public companies like Twitter and Facebook.”); John Carney, *Insider Trading in Silicon Valley*, CNBC (Apr. 4, 2011, 10:39 AM ET), http://www.cnbc.com/id/42413987/Insider_Trading_in_Silicon_Valley (quoting a venture capitalist as asking the author, “How can there be an insider trading issue in the Valley if everyone buying is basically an insider?”).

²¹⁹ See, e.g., Jessica E. Vascellaro, *Facebook Implements Insider-Trading Policy*, WALL ST. J. DIGITS BLOG (Apr. 5, 2010, 7:15 PM), <http://blogs.wsj.com/digits/2010/04/05/facebook-implements-insider-trading-policy> (discussing how Facebook instituted an insider trading policy in 2010, while still a private company, “to better comply with insider trading laws and to protect the interests of the company and its employees and shareholders” (internal quotation marks omitted)); see also Stone, *supra* note 83 (discussing how Facebook, while still a private company, fired an employee for violating the company’s policy against trading in company stock). Legal implications aside, a company might seek to reduce the likelihood of insider trading in order to protect against the reputational injury that might result if insider trading by corporate managers or employees were to come to light. See Stephen M. Bainbridge, *The Law and Economics of Insider Trading: A Comprehensive Primer* 78 (2001) (unnumbered working paper), available at http://ssrn.com/abstract_id=261277 (discussing possible reputational injury to corporations from insider trading by corporate managers).

²²⁰ See SAWYER ET AL., *supra* note 30, at 28–29.

²²¹ See *supra* note 191.

Alternatively, if the company is not willing to make disclosures and the shareholder is not selling pursuant to an established trading window, the party possessing the material nonpublic information might try to obtain a "big boy letter" in connection with the sale.²²² A big boy letter is an "agreement . . . between parties to a securities transaction where one party, typically the seller, has material nonpublic information that it does not want to disclose, but both parties want to complete the transaction and preclude any claims based on the nondisclosure."²²³ The letter typically includes a list of representations and a waiver of claims, essentially stating that the party is a "big boy" who elects to proceed with a transaction, even knowing the risks of doing so.

But while a big boy letter might discourage or provide defenses in private actions, it is not clear that such a letter would protect against government enforcement of insider trading laws. After all, the SEC is not a party to big boy letters. Moreover, the government could potentially show that a defendant deceived the source of the material nonpublic information by not disclosing his trading activities to the source, or that he deceived the counterparty by not disclosing the specific nature and scope of the information.²²⁴ Indeed, SEC officials have suggested unofficially that big boy letters would not provide a defense to insider trading charges.²²⁵ In addition, the SEC has recently shown particular concern about insider trading by hedge funds, firms that frequently transact using big boy letters.²²⁶

²²² See SAWYER ET AL., *supra* note 30, at 31 (recommending, with reservations, the use of big boy letters to "provide disclosure to the [outside party] and [acknowledge] the dynamics that exist between the sophisticated buyer and seller transacting on an arm's length basis").

²²³ Edwin D. Eshmoili, Note, *Big Boy Letters: Trading on Inside Information*, 94 CORNELL L. REV. 133, 135 (2008) (footnote omitted); see also DONALD C. LANGEVOORT, 18 INSIDER TRADING: REGULATION, ENFORCEMENT & PREVENTION § 3:19 (2012) (explaining that big boy letters "state that the buyer of securities is not relying on any information provided or not provided by the seller").

²²⁴ See Goodwin Procter Memo, *supra* note 200, at 6-7 (discussing how big boy letters "do not eliminate the risk of insider trading liability" and noting that "SEC officials have said that big boy letters will not affect SEC enforcement proceedings").

²²⁵ Eshmoili, *supra* note 223, at 156; see also, e.g., Complaint at 4-5, SEC v. Barclays Bank PLC, No. 07-04427 (S.D.N.Y. May 30, 2007) (describing insider trading charges against the bank and a proprietary trader despite the use of big boy letters to advise counterparties about possession of material nonpublic information); Rachel McTague, 'Big Boy' Letter Not a Defense to SEC Insider Trading Charge, *Official Says*, 39 SEC. REG. & L. REP. (BNA) 1832 (Dec. 3, 2007).

²²⁶ See Jenny Anderson, *Side Deals in a Gray Area*, N.Y. TIMES, May 22, 2007, at C1 (discussing an SEC case involving big boy letters and a hedge fund); SEC Staff Considers Use of 'Big Boy' Letters, Bingham McCutchen (Jan. 15, 2008) (on file with author) (discussing the SEC's "renewed interest" in insider trading cases involving big boy letters).

In sum, Rule 10b-5 is phrased broadly; its language covers private company stock and there are limited ways for participants in secondary markets to try to avoid or minimize insider trading. SecondMarket and SharesPost may require the parties to represent that they are not trading on the basis of material nonpublic information, but such representations may in actuality do little to prevent insider trading. Accordingly, the question arises as to how the government might or should respond—a question the next Part endeavors to answer.

IV. POSSIBLE RESPONSES TO INFORMATION ISSUES IN THE SECONDARY MARKETS FOR PRIVATE COMPANY STOCK

The previous Parts have built on existing literature recognizing the potentially beneficial role of the secondary markets for private stock, while drawing new attention to significant information issues in these markets. The secondary markets are still relatively new, and their future is unclear. Thus, the practical challenge going forward is determining whether these markets should be embraced, whether adequate responses to the information issues can be devised, and, more broadly, whether the markets can be regulated in a way consistent with the SEC's mandate to promote investor protection, capital formation, and market integrity. This Part explores potential responses to the information issues.

A. *Lack of Information, Asymmetric Information, and Conflicts of Interest*

Virtually no legal scholarship has offered a response to the information issues that threaten the legitimacy and efficiency of these markets. Popular media commentary addressing the issue has varied primarily between two polar viewpoints. Some observers have argued that the markets should be allowed to flourish unfettered since accredited investors are either sophisticated or wealthy enough to withstand a loss.²²⁷ Conversely, others have expressed strong reservations about the surging, perhaps bubble-like, and potentially inaccurate valuations of some companies on these markets, suggesting that these markets should be subject to more regulatory oversight.²²⁸

²²⁷ See, e.g., Sarah Lacy, *Back Off SEC: Let's Put the "Risk" of Secondary Markets in Perspective*, TECHCRUNCH (Dec. 29, 2010), <http://techcrunch.com/2010/12/29/back-off-sec-lets-put-the-risk-of-secondary-markets-in-perspective> (arguing that, since trading is restricted to accredited investors, the SEC should "stay out of the system until companies start crossing clear lines").

²²⁸ See, e.g., Liz Gannes, *Does the LinkedIn IPO Validate Secondary Market Trading?*, ALLTHINGSID (May 19, 2011, 1:00 AM PST), <http://allthingsid.com/20110519/does-the-linkedin-ipo-validate-secondary-market-trading> (lamenting that secondary market investors "must make stock buys based on hype and expectations"); Jeff Macke, *Avoid Social Media Frenzy on Secondary*

This Article argues for a middle path. The Supreme Court established more than a half-century ago that sophisticated investors do not need the same protections as the unsophisticated.²²⁹ With access to information, sophisticated investors are presumably able to “fend for themselves.”²³⁰ That is, they are assumed to be in a position to get the information they need before investing or, alternatively, to take any lack of information into consideration in pricing stock.²³¹ As only accredited investors and QIBs can buy private company stock on the secondary markets, there is arguably no need to expand regulation of secondary trading of private company stock. Yet, as Section III.A explained, investors on these private secondary markets may not have the appropriate type and amount of information, and access to this information may be difficult to obtain, particularly as investors are not in privity with the company in a secondary transaction. Given that the relevant regulatory structure was devised years before the rise of these new private secondary markets, some regulatory tweaking may be necessary to strengthen the markets and promote investor protection.

This Article proposes two reforms to this end: a specified minimum level of disclosure for private secondary trading to fit within a registration exemption and a reevaluation of the accredited investor standard.

One way to address the lack of information and the asymmetric information in the secondary markets would be for the SEC to require a certain minimum level of disclosure in order for private company stock to be traded in secondary transactions. The SEC could issue new rules or interpretive guidance that specified certain disclosures required for secondary transactions to fit within the established securities exemptions. For instance, the SEC could amend Rule 144 such that both affiliates and nonaffiliates would be subject to information requirements.

The information required could include basic information critical to evaluating a company's financial fundamentals and stock value. The disclosure required under Rule 701 of the Securities Act could serve as a

Markets, YAHOO FIN. (June 7, 2011, 11:58 AM EDT), <http://finance.yahoo.com/blogs/breakout/avoid-social-media-frenzy-secondary-markets-macke-155809254.html> (arguing that the SEC should regulate secondary markets because outsiders will “lose big” due to the limited information about private companies and the likelihood of insider trading in these markets).

²²⁹ See *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953) (declaring that transactions should be exempt from the Securities Act if “there is no practical need for [the Act’s] application” (internal quotation marks omitted)).

²³⁰ *Id.*

²³¹ See ROBERT CHARLES CLARK, *CORPORATE LAW* § 17.3 (1986) (“Institutional investors are usually sophisticated and powerful enough to demand and get the information they need . . .”).

useful reference point.²³² Rule 701 provides a registration exemption for compensatory stock options, and requires private companies issuing over \$5 million in stock options within a twelve-month period to provide option-holders with risk information and financial statements no more than 180 days old.²³³ The SEC could also consider, by contrast, less and more stringent reference points—such as the Rule 144 exemption for affiliates selling restricted stock, and the full registration requirements or the JOBS Act on-ramp for newly public companies.²³⁴ In addition to considering these reference points, the SEC should seek public comment and engage in cost-benefit analysis to require disclosures properly tailored to the private secondary market context.²³⁵

The goal would not be to replicate the extensive governance and reporting requirements of public companies, but rather to standardize a modest level of required information that would not overly burden the private companies and that sophisticated investors would find critical for basic valuation.²³⁶ In other words, the disclosure requirement is meant to address the concern that there is not enough information available to make prudent

²³² See 17 C.F.R. § 230.701(e) (2012) (listing required disclosures). Exchange Act Rule 12h-1 provided a similar registration exemption under the Exchange Act; the JOBS Act extended this relief by excluding from the Section 12(g) definition of record holders any persons who received securities pursuant to an employee compensation plan exempt from the Securities Act registration requirements. See *supra* note 73.

²³³ 17 C.F.R. § 230.701(e); see also HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, 3 SECURITIES & FEDERAL CORPORATE LAW § 3:38 n.19 (2005) (further specifying the financial statements required to be disclosed). Companies may make the disclosures on a password-protected Internet site and are permitted to condition disclosure on the optionholder's agreement to maintain the confidentiality of the agreement. 17 C.F.R. § 240.12h-1 (f)(1)(vi) & (note); Exemption of Compensatory Employee Stock Options from Registration Under Section 12(g) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-56887, 72 Fed. Reg. 69,554 (Dec. 7, 2007).

²³⁴ See *supra* note 5 and accompanying text; *supra* note 41; *supra* note 57 and accompanying text. Rule 144 requires disclosure of current information about the issuer, principally the company's most recent balance sheet, profit and loss statement, and retained earnings statement for the last and preceding fiscal years. 17 C.F.R. §§ 230.144(c)(2) & 240.15c2-11(a)(5). There is no requirement that the information be audited, and the standard for "reasonably current" information under Rule 144(c)(2) is relatively lax. See Michael K. Molitor, *Will More Sunlight Fade the Pink Sheets? Increasing Public Information About Non-Reporting Issuers with Quoted Securities*, 39 IND. L. REV. 309, 335-38 (2006) (discussing the low information and timeliness standards under Rule 15c2-11, incorporated by Rule 144(c)).

²³⁵ For a discussion of the difficulties of doing cost-benefit analysis, and its role in SEC policymaking, see Donald C. Langevoort & Robert B. Thompson, "Publicness" in *Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. (forthcoming 2012), available at http://ssrn.com/abstract_id=1984686.

²³⁶ See *id.* (manuscript at 31) ("[A] disclosure regime makes sense, though we have to balance this benefit against the risk that government-mandated disclosure will turn out not to be cost-efficient.").

decisions, regardless of an investor's accredited status.²³⁷ As one managing director of an investment firm said, "It's hard enough to get information on Facebook. I'm an accredited [investor], I have an M.B.A. in finance, how do I know what these things should be valued at?"²³⁸ A moderate mandatory disclosure rule could correct for a market failure in information production and thereby strengthen these markets.²³⁹

As this requirement could be structured as specific guidance for fitting any given transaction within an exemption, the information would not have to be disclosed to the public at large, but rather only to the secondary transaction participants. Such a requirement would allow companies to continue to use secure electronic data rooms and confidentiality agreements to maintain some level of control and confidentiality. Mature private companies whose stock is likely to be traded on secondary markets may have already prepared the same type of information for compliance with the disclosure requirements of Rule 701, and possibly for affiliate sellers who have sold stock pursuant to Rule 144.

This idea reflects changes in the venture capital cycle—that the lengthening period of time from a company's formation to a major liquidity event has created mature private companies that straddle or blur the lines between previously held notions of public and private.²⁴⁰ SharesPost has said that it is "trying to create an interim market between the VC investing world and

²³⁷ See *id.* (manuscript at 32) ("An active trading market disconnected from [private bargaining over allocation of capital to the issuer], even among the sophisticated or wealthy, will not by itself generate a socially optimal amount or type of information.").

²³⁸ Rusli, *supra* note 95.

²³⁹ Mandatory disclosure in the public markets is premised on the idea that the optimal amount of information will not be produced if left to normal market forces and that information is a public good. Explanations have been framed in terms of investor protection and efficiency, and grounded on benefits to investors and society more broadly. For an overview of mandatory disclosure literature, see generally FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 286-314 (1991); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 734-37 (1984); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 680-96 (1984); Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1369-95 (1999); Michael D. Guttentag, *An Argument for Imposing Disclosure Requirements on Public Companies*, 32 FLA. ST. U. L. REV. 123, 186-88 (2004); Geoffrey A. Manne, *The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure*, 58 ALA. L. REV. 473, 478-85 (2007); and Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 10-45 (1983). For a recent survey of literature on financial reporting, see generally Anne Beyer et al., *The Financial Reporting Environment: Review of the Recent Literature*, 50 J. ACCT. & ECON. 296 (2010).

²⁴⁰ See generally Langevoort & Thompson, *supra* note 235 (discussing the "public-private divide" in securities regulation).

the public markets;²⁴¹ this proposal would establish a corresponding interim level of disclosure. This idea might become increasingly important as the secondary markets continue to develop and change, particularly in times of bubble-like exuberance.²⁴²

The idea has limitations, however, and some of the concerns about information issues in these markets would likely remain. One can imagine scenarios where, despite the availability of certain basic information, private companies would not disclose other important information for valuing their stock. Participants in these markets would still have to make their own determinations of whether they had sufficient information to make investment decisions. This proposal would only set a standard minimum level of disclosure to address a fundamental information failure.

Furthermore, while an interim level of disclosure responds to the lack of information and asymmetric information, it does not directly address conflicts of interest. While a certain base level of information might help counteract biased research reports, a separate response to the conflict of interest issue may be necessary.

In addition, there is, of course, a cost associated with requiring disclosure, however modest. Companies could be concerned that the information disclosed would not remain confidential and might refuse to make the required disclosures, effectively preventing shareholders from selling their stock on the secondary markets. Such a move could decrease the liquidity of some private company stock relative to the current situation, and constrain the growth of these markets. Furthermore, a minimum information mandate might require more company involvement than SharesPost currently includes in its model. Requiring information disclosures might necessitate moving to a model that creates controlled liquidity events rather than one that aims for an active marketplace.

The cost could, however, be kept moderate, similar to Rule 701's information requirements, which apply to companies issuing significant stock

²⁴¹ Yarow, *supra* note 10.

²⁴² For example, if the markets were to develop in such a way that higher value or more mature firms constrained trading in their stock, but riskier, lower value firms did not, information standards might become even more important. See Guttentag, *supra* note 70, (manuscript at 35) (discussing the "lemons" problem, witnessed in European markets, which predicts negative spillover effects in markets where firms provide only limited amounts of information); *see also* Gannes, *supra* note 41 (noting that one well-regarded VC firm has started instructing its portfolio companies to include a right of first refusal on all stock options so that they can buy stock back instead of allowing outside transactions).

options or compensatory equity awards.²⁴³ If so, many companies might voluntarily cooperate, as evidenced by SecondMarket's newer business model, which is based on significant issuer involvement. While companies may be sensitive to the number of shareholders and other concerns related to secondary trading,²⁴⁴ they may also find they benefit in the long run from the presence of vibrant secondary markets.²⁴⁵ Further, over time, investors may be able to exert leverage over companies for minimal disclosures, either because of their size or number.

A second way to address concerns about information issues is to re-examine the definition of "accredited investor," established in Rule 501 of Regulation D.²⁴⁶ This proposal does not directly deal with the amount or quality of information available, but rather addresses the concern that there are individuals participating in the secondary markets who cannot fend for themselves.

The definition of "accredited investor" aims to capture investors who are sophisticated enough to make their own trades, or who can afford to hire advisors, and so do not need securities law protections.²⁴⁷ Net worth and income serve as objective proxies for this ability to fend for oneself.²⁴⁸ As a result, the accredited investor definition is notoriously under- and over-inclusive.²⁴⁹ It is underinclusive because financially knowledgeable investors may not meet the minimum wealth requirements for accredited status, and overinclusive because wealthy individuals without financial sophistication may qualify as accredited.

Moreover, despite various narrow SEC proposals and small modifications in the Dodd-Frank Act,²⁵⁰ the definition has not changed substantially

²⁴³ See *supra* notes 232-33 and accompanying text.

²⁴⁴ See *supra* notes 65-74, 200 and accompanying text.

²⁴⁵ See *supra* Part II.

²⁴⁶ See *supra* note 52 and accompanying text.

²⁴⁷ See Roberta S. Karmel, *Regulation By Exemption: The Changing Definition of an Accredited Investor*, 39 RUTGERS L.J. 681, 683 (2008) (noting that such an investor "generally is defined in terms of wealth, on the theory that an accredited investor can hire knowledgeable and sophisticated advisors"); *supra* notes 42-52 and accompanying text.

²⁴⁸ See *supra* note 52 and accompanying text.

²⁴⁹ See Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CALIF. L. REV. 279, 310-11 (2000) (noting that the term "may treat otherwise financially sophisticated investors as nonaccredited, while treating financial neophytes as accredited"); Wallis K. Finger, Note, *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition Under the 1933 Act*, 86 WASH. U. L. REV. 733, 748 (2009) (observing that "a financial novice" can be accredited "based upon the accident of being rich").

²⁵⁰ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 413(a), 124 Stat. 1376, 1577 (2010) (adjusting the accredited investor standard for natural persons

since it was promulgated in 1982,²⁵¹ and the minimum net worth and income requirements are arguably outdated.²⁵² With inflation and growth in wealth, many more individuals today meet the requirements than when the guidelines were set.²⁵³

A reexamination of the definition could look at whether the objective threshold should be raised as well as whether another component should be added or substituted to minimize the under- and over-inclusiveness.²⁵⁴ The net worth or income test may be a better proxy for sophistication and access to information in the context of primary issuances, where the investor is in privity with the issuer, than in secondary trading, where the investor is not and may have more difficulty gaining access to information.²⁵⁵ It would thus be worthwhile to study whether proposals for other components such as a licensing scheme, strengthened suitability requirements on broker-dealers, or a move to a multi-factored approach would better serve stated goals in this secondary context.²⁵⁶ In short, the thresholds may be too low and too

so that the net worth requirement is \$1 million, excluding the value of the investor's primary residence); Finger, *supra* note 249, at 734-36 (noting that in 2006 and 2007 the SEC proposed alternative definitions of accredited investor). The Dodd-Frank Act also requires the SEC to periodically review the accredited investor standard and adjust it "as the Commission may deem appropriate for the protection of investors, in the public interest, and in light of the economy." Dodd-Frank Act § 413(b)(1)(B).

²⁵¹ Finger, *supra* note 249, at 743.

²⁵² Karmel, *supra* note 247, at 681.

²⁵³ See SEC Proposes Liberalization of Private Placement Requirements, MORRISON FOERSTER (Aug. 9, 2007), <http://www.mofo.com/pubs/xpqPublicationDetail.aspx?xpST=PubDetail&pub=7867> (noting that, due to inflation, the percentage of American households qualifying as accredited investors has increased from approximately 1.64% of households in 1982 to approximately 8.47% of households).

²⁵⁴ See Donald C. Langevoort, *Angels on the Internet: The Elusive Promise of "Technological Disintermediation" for Unregistered Offerings of Securities*, 2 J. SMALL & EMERGING BUS. L. 1, 22 (1998) (expressing "skepticism about the self-protective abilities of seemingly sophisticated investors" and suggesting a careful empirical study of investment decisionmaking of investors in private securities offerings, including "solid demographic work, as well as inquiry into the process and influences on purchase decisions").

²⁵⁵ See Langevoort & Thompson, *supra* note 235, at 30-31 ("'Fending for oneself' is easier when the investor is in privity or near-privity with the issuer, because representations and warranties can be extracted fairly directly; in aftermarket trading, by contrast, the link between issuer and investor is broken.").

²⁵⁶ See Choi, *supra* note 249, at 284 (re-imagining the federal securities law regime to classify investors into four groups based on their knowledge and resources, using a licensing system); Fletcher, *supra* note 42, at 1149-54 (suggesting a multi-factored approach to decide whether an investor is sophisticated, using investor-specific information); Finger, *supra* note 249, at 759-62 (criticizing the accredited investor definition and proposing a licensing scheme to supplement the current definition); Howard M. Friedman, *On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291, 313-14 (1994) (expressing

imprecise to ensure that investors can fend for themselves in secondary markets for private company stock, where the protections of the public markets are not present.

Providing guidance or modest regulatory reform on information disclosure and the accredited investor thresholds will serve investor protection and market integrity goals, and in turn allow the secondary markets to grow and evolve.

B. *Insider Trading*

Increasing the minimum information disclosed, as suggested above, might help reduce information asymmetries in the secondary markets, and in turn might reduce insider trading. Yet, as the proposal does not recommend the disclosure of *all* material information, there is no reason to believe that setting a minimum level of information disclosure would eliminate insider trading. Traders could still possess nonpublic, material information and be in a position to benefit by trading on that information, in breach of a fiduciary duty or relationship of trust or confidence. Thus, even with the proposed information requirement, concerns about insider trading in the private secondary markets would remain.

A scholarly debate about whether insider trading should be regulated at all has raged for over half a century.²⁵⁷ Critics of insider trading regulation have argued that insider trading increases share price efficiency, causes no harm to other traders, is an efficient compensation scheme for managers, and mitigates agency costs.²⁵⁸ Supporters of insider trading regulation have argued that insider trading is unfair, does not contribute significantly to price efficiency, may reduce investor confidence in securities markets, increases transaction costs and decreases market liquidity by increasing bid-ask spreads, constitutes a misappropriation of information and wealth better assigned to the corporation, and creates perverse incentives for manage-

concerns about the treatment of wealthy, unsophisticated, accredited investors, and proposing "a more meaningful suitability requirement").

²⁵⁷ For the seminal work that sparked this debate, see HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966).

²⁵⁸ For literature describing the various arguments for why insider trading should not be regulated, see MACEY, *supra* note 142, and MANNE, *supra* note 257. Cf. Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 868 (1983) ("[C]ommunicating information through insider trading may be of value to the firm."); Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 54-55 (1980) (noting that insider trading regulations, if they are to be justified, cannot be justified on the basis of protecting consumers since they typically do not).

ment.²⁵⁹ Policy prescriptions have run the gamut from proposals that insider trading be fully legalized²⁶⁰ or partially legalized²⁶¹ to claims that it should be more aggressively tracked and punished.²⁶² Despite extensive literature and a multitude of empirical studies, scholars have not reached a conclusive resolution in the debate.²⁶³ As a practical matter, however, the SEC and the courts have long enforced the insider trading prohibition, and so this Section starts from that premise. This Section does not seek to rehash the debate about insider trading generally, but rather focuses on potential responses in the specific context of the private secondary markets.

The SEC is in the unfortunate position of choosing between imperfect paths of action regarding insider trading in private company stocks. Each of the three options outlined below comes with some drawbacks. The choice is particularly difficult as pertinent empirical questions, such as how much insider trading is actually taking place in the secondary markets and to what extent market participants are aware of the level of insider trading, remain unanswered.

One option for the SEC is proactively to enforce existing insider trading laws in the secondary markets. The SEC could take a two-pronged approach by issuing guidance, similar to its approach on insider trading policies and big boy letters, as well as launching investigations into specific transactions. Doing so would draw attention to the applicability of insider trading laws to private company stock and put investors on notice. It would

²⁵⁹ For literature describing the various arguments why insider trading should be regulated, see LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* 762 (3d ed. 1995); Brudney, *supra* note 205, at 327-28; Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 330-33; Nicholas L. Georgakopoulos, *Insider Trading as a Transactional Cost: A Market Microstructure Justification and Optimization of Insider Trading Regulation*, 26 CONN. L. REV. 1, 17-46 (1993); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 630-32 (1984); Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051, 1051-53 (1982); Ian B. Lee, *Fairness and Insider Trading*, 2002 COLUM. BUS. L. REV. 119; Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 122 (1982); and Kenneth E. Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801, 817-18 (1980).

²⁶⁰ See, e.g., Henry G. Manne, *Insider Trading: Hayek, Virtual Markets, and the Dog that Did Not Bark*, 31 J. CORP. L. 167 (2005).

²⁶¹ See, e.g., Thomas A. Lambert, *Overvalued Equity and the Case for an Asymmetric Insider Trading Regime*, 41 WAKE FOREST L. REV. 1045, 1096-98 (2006) (suggesting that price-decreasing insider trading should be allowed but not price-enhancing insider trading).

²⁶² See, e.g., Prentice, *supra* note 209, at 379 (asserting that insider trading laws support ideals of fairness, protect corporations' property, and aid economic efficiency).

²⁶³ Stephen Clark, *Insider Trading and Financial Economics: Where Do We Go From Here?*, 16 STAN. J.L. BUS. & FIN. 43, 57 (2010).

also give the SEC the opportunity to provide helpful clarification as to proper practices for private companies opening trading windows, and would be in line with the SEC's revived interest in insider trading generally.²⁶⁴ Further, recent empirical work suggests that insider trading enforcement is associated with increased liquidity and lower cost of equity.²⁶⁵

As a practical matter, though, it may be difficult to police insider trading in private company stock. Illegal insider trading is generally quite difficult to prove—traders can hide behind proxies, it can be hard to determine what the trader knew at the time of the trade, and direct evidence is rare.²⁶⁶ Indeed, the SEC itself has acknowledged this difficulty.²⁶⁷ And it may be even more challenging for the government to detect insider trading in the private company stock context because stock prices and trading information are not publicly available and no baseline of publicly reported information exists.

Moreover, an aggressive approach has the potential to squash the online secondary markets while they are still in a delicate initial stage. Many shareholders might have access to material nonpublic information, or seem as though they might,²⁶⁸ and, after seeing an insider trading case in the headlines, might not be willing to sell due to fears of investigation or liability. With increased attention on insider trading in these markets, outsiders may fixate on—or overestimate—the risk of buying from insiders²⁶⁹

²⁶⁴ The government has recently brought novel insider trading charges in a variety of cases, including its prosecution of one of the biggest insider trading cases in history. See Prentice, *supra* note 209, at 344 & n.1 (describing recent insider trading cases involving instruments such as credit default swaps, new theories such as under 18 U.S.C. § 1348, and defendants such as employers, famous billionaires, and administrative assistants).

²⁶⁵ See Laura Nyantung Beny, *Insider Trading Laws and Stock Markets Around the World: An Empirical Contribution to the Theoretical Law and Economics Debate*, 32 J. CORP. L. 237, 240, 273-80 (2007) (finding that "countries with more stringent insider trading laws have more dispersed equity ownership; more liquid stock markets; and more informative stock prices"); Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75, 104 (2002) ("[E]nforcement of insider trading laws . . . is associated with a reduction in the cost of equity in a country."). But see Stanislav Dolgoplov, *Insider Trading and the Bid-Ask Spread: A Critical Evaluation of Adverse Selection in Market Making*, 33 CAP. U. L. REV. 83, 144-49 (2004) (questioning the causal link between regulation and market liquidity).

²⁶⁶ Clark, *supra* note 263, at 47-48.

²⁶⁷ See *id.* at 64 n.130 (quoting testimony of an SEC director that insider trading cases "are unquestionably among the most difficult cases we are called upon to prove, and despite careful and time-consuming investigations, we may not be able to establish all of the facts necessary to support an insider trading charge").

²⁶⁸ See *supra* note 216 and accompanying text.

²⁶⁹ Cf. Amos Tversky & Daniel Kahneman, *Availability: A Heuristic for Judging Frequency and Probability*, in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 163 (Daniel Kahneman et al. eds., 1982).

and subsequently lose confidence in the secondary markets. In turn, that lost confidence could decrease liquidity and increase the cost of capital.²⁷⁰ Responses are difficult to predict, however, as arguably outsiders might have increased confidence in the markets upon seeing government oversight.²⁷¹

Another option is for the SEC to do nothing—to take a wait-and-see approach, without taking significant actions to investigate insider trading or issue guidance. This approach may be a sensible one for now, as the markets are still developing, and over time their role and size will become clearer. And in the meantime, to the extent that insider trading allows information to be impounded in the price of securities, insider trading in these markets might be increasing pricing efficiency.²⁷² Corporate insiders tend to have the best information about the company's financial health and prospects, and when they buy or sell their company's stock "they convey valuable information to the marketplace."²⁷³ Improved pricing efficiency may also lead to a more efficient allocation of resources.²⁷⁴

But this do nothing or wait-and-see approach also has its drawbacks. Participants would continue to face uncertainty about SEC views if it did not act or issue guidance. In addition, the SEC could face mounting political pressure to regulate. It could face harsh criticism if egregious examples of insider trading were to come to light amid lax enforcement. Further, supporters of an insider trading prohibition might worry that the incidence of insider trading in private company stock would increase as insiders discovered they could get away with it. And if outsiders perceived an unchecked insider trading problem, they might refuse to participate or excessively discount prices.²⁷⁵ As previously noted, however, it is difficult to

²⁷⁰ For a discussion of how liquidity may affect the cost of equity, see, for example, MAUREEN O'HARA, *MARKET MICROSTRUCTURE THEORY* (1995); Yakov Amihud & Haim Mendelson, *Asset Pricing and the Bid-Ask Spread*, 17 J. FIN. ECON. 223, 246 (1986); and Michael J. Brennan & Avanidhar Subrahmanyam, *Market Microstructure and Asset Pricing: On the Compensation for Illiquidity in Stock Returns*, 41 J. FIN. ECON. 441, 459 (1996).

²⁷¹ See Clark, *supra* note 263, at 58 (considering the argument that outsiders would lose confidence in a market where insiders can use material nonpublic information to make abnormal profits in trades with outsiders).

²⁷² See Manne, *supra* note 260, at 169 ("[T]he argument for a strong positive relationship between market efficiency and insider trading has proved to be very robust."). But see Gilson & Kraakman, *supra* note 259, at 632 (arguing that it would aid efficiency if insiders were required to disclose their identity and the size of their trade before trading).

²⁷³ Lambert, *supra* note 261, at 1054.

²⁷⁴ *Id.*

²⁷⁵ See, e.g., Macke, *supra* note 228 (calling buyers of private company stock in secondary markets "the quintessential suckers at the poker table, regardless of whether they make the couple hundred thousand a year needed to qualify as accredited").

predict whether government pursuit of insider trading cases in the secondary markets would encourage or discourage participation.²⁷⁶

Finally, at the other end of the spectrum, Congress or the SEC could affirmatively create a safe harbor from the insider trading prohibition for secondary trading of private company stocks. To the extent that insider trading is difficult to avoid in the context of private company stock, a safe harbor would provide valuable clarity and latitude. Such a move would make sense if the SEC were to determine that the benefits of the secondary private markets outweighed the value or importance of enforcing insider trading laws in this area. The safe harbor might also serve as a useful experiment for testing the frequently made argument in favor of deregulation—essentially, that corporations should (and will) set their own insider trading policies by contract.²⁷⁷ Further, as buyers in the secondary markets must be either QIBs or accredited investors, one could argue in favor of treating insider trading differently in these markets than in public markets. In theory, participants in the private secondary markets should have the sophistication to understand the risks they face and to address them by inquiring into their counterparties' information, requiring a representation that they are not trading on inside information, or adjusting the price at which they are willing to trade.²⁷⁸ Participants should also have the financial capability to withstand losing money on an investment.

Like the other options, this safe harbor approach also has its downsides. As with the do nothing or wait-and-see approach, it is possible that a safe harbor for insider trading in the private secondary markets may lead outsiders to refuse to participate or to discount prices excessively, which could have deleterious effects on the private secondary markets. Further, if one believes that insider trading should be prohibited in general, the reasoning applies with equal force in the private context. Finally, despite arguments about the sophistication of investors in the private secondary markets, the SEC may have concerns about adopting an inconsistent policy across markets.

While there is a relatively clean slate in choosing between these options, one might make the uneasy case for the first approach of enforcement and

²⁷⁶ See *supra* text accompanying note 271.

²⁷⁷ See Carlton & Fischel, *supra* note 258, at 863 (applying the Coase theorem to insider trading and arguing that private ordering will result in optimal allocation of property rights in information); see also David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 NW. U. L. REV. 1449 (1986) (expanding application of the Coase theorem to insider trading).

²⁷⁸ See Scott, *supra* note 259, at 807-09 (noting that if insider trading is known, outsiders will not be disadvantaged because the price they pay will reflect the risk of insider trading).

guidance by observing that the arguments in favor of insider trading regulation in the public company context are at least as strong and perhaps stronger in the private marketplace. Since the SEC actively enforces insider trading in public markets, it seems to follow that it would do so in the private context.

To start, while the argument that insider trading contributes to share price efficiency²⁷⁹ maintains its strength in the private company stock context, the other key anti-regulation argument—that insider trading causes no harm—arguably does not.²⁸⁰ The argument that insider trading causes no harm is premised on a liquid, impersonal market. It posits “that no real damage is caused to an investor who engages anonymously on an exchange in a trade with an insider on the other side of the transaction”²⁸¹ because “the seller has made an independent decision to sell without knowing that the insider is buying; if the insider were not buying, the seller would still sell.”²⁸² The new secondary markets for private company stock are not liquid and impersonal like public markets, however. These markets are thinly traded, and at times posted offers to buy or sell go unmatched.²⁸³ Thus, in some instances, if the insider did not buy or sell, the transaction would not otherwise occur. Further, trades in the private market are customized transactions between two identifiable parties.²⁸⁴ Thus, insider trading may indeed harm individual investors in the private company stock context.

²⁷⁹ For counterarguments that insider trading causes efficiency losses, see Lambert, *supra* note 261, at 1050-51.

²⁸⁰ In his seminal work, *Insider Trading and the Stock Market*, Henry Manne actually made three arguments against regulating insider trading, but he has since largely discounted one of them, and thus this Article does not address it. See Manne, *supra* note 260, at 170-71 (“My second ‘positive’ argument for insider trading, that it could perform well as a part of an executive compensation package, has been the more forcefully attacked, and it is perhaps less robust than I and other proponents had originally assumed.” (footnotes omitted)).

²⁸¹ Manne, *supra* note 260, at 168.

²⁸² Bainbridge, *supra* note 219, at 72.

²⁸³ See generally Yarow, *supra* note 10 (quoting the SharesPost CEO commenting on the varying levels of activity in the private marketplace).

²⁸⁴ See *supra* Section I.B. Uninformed outsiders can be expected to systematically lose in trades with insiders. See Lee, *supra* note 259 at 160-61 (“Since insiders will only buy when stock is undervalued and sell when stock is overvalued, outside investors who trade simultaneously with and in the opposite direction from insiders will always be buying when the price is too high or selling when the price is too low.”); see also Walter Bagehot, *The Only Game in Town*, FIN. ANALYSTS J., Mar.-Apr. 1971, at 12, 13 (showing that market makers always lose to informed traders).

Furthermore, the arguments against insider trading maintain their weight in the private stock context. For example, despite scholarly criticism,²⁸⁵ unfairness has been one of the primary rationales for prohibiting insider trading.²⁸⁶ There is no reason to believe concerns about fairness would be different in the private secondary market context. Observers have asserted that the unfairness in insider trading stems from insiders' unequal access to information, their ability to act against their principals' interests for their own personal profit, and their ability to profit in a way that is not correlated with any value created for their firms.²⁸⁷ These perceived sources of unfairness apply equally well to insiders trading in private company or public company stocks.

Another argument for imposing insider trading liability which also maintains its strength in the private company context is that the prohibition protects corporations' property interests in information. In brief, a rule allowing insider trading assigns a property interest in the nonpublic information to the insider, whereas a rule prohibiting insider trading assigns it to the corporation. The property-based approach maintains that assigning the right to the corporation is better because it "protect[s] the economic incentive to produce socially valuable information."²⁸⁸ Notably, allowing insider trading in private company stock would still effectively assign a property right to corporate information to insiders—and there still would not be a good reason for doing so.

In sum, the SEC has a difficult path to navigate in deciding how to handle insider trading in private company stock. All of the SEC's options—to

²⁸⁵ See, e.g., Manne, *supra* note 260, at 182 n.60 (criticizing fairness arguments against insider trading as "puerile"); Bainbridge, *supra* note 219, at 71 (arguing that we cannot articulate a definition of fairness that sufficiently justifies the insider trading prohibition and that most definitions of fairness "collapse into . . . efficiency-based rationales").

²⁸⁶ E.g., Prentice, *supra* note 209, at 380-81; see also, e.g., Jesse M. Fried, Essay, *Insider Abstinence*, 113 YALE L.J. 455, 456 (2003) ("Although academics still debate the economic desirability of insider trading, the consensus among the American public, Congress, and the SEC is that insider trading is 'unfair' and erodes investor confidence in the market."); James J. Park, *Rule 10b-5 and the Rise of the Unjust Enrichment Principle*, 60 DUKE L.J. 345, 362 n.82 (2010) (noting that it may be unjust to allow insiders to take advantage of informational asymmetry because the insider has obtained information specifically by virtue of his position rather than by deliberately acquiring information (citing Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 13 (1978))).

²⁸⁷ See Prentice, *supra* note 209, at 379-83 (summarizing fairness arguments).

²⁸⁸ Bainbridge, *supra* note 219, at 78-79. In addition, the case for assigning the right to insiders is arguably weak because insider trading is "an inefficient compensation scheme." *Id.* at 80; see also Manne, *supra* note 260, at 170-71 n.14 (acknowledging weaknesses in the argument for viewing insider trading as executive compensation).

enforce insider trading laws proactively, to do nothing, or to create a safe harbor—come with pros and cons. This Section takes as a given the current regime and observes that the argument for enforcing insider trading liability remains at least as strong in the private market context as in the public, and is perhaps stronger because arguably insider trading causes harm on these less liquid, more personal markets. This observation is made with some caution, however, as enforcing insider trading laws in private company stock has to date been relatively rare. Likewise, empirical facts such as how often insider trading occurs in these markets and its effect on the markets are unknown.

V. THE TENSION BETWEEN PRIVATE AND PUBLIC MARKETS

The previous Parts have examined the secondary markets for private company stock, information issues in these markets, and potential responses to these concerns. This Part seeks to tie this examination to broader policy questions and provide some preliminary observations.

In short, fostering the growth of private markets implicates an underlying tension with public markets and the policy rationales that undergird the divide between public and private companies. The new secondary markets have the potential to play an important role in the private company ecosystem, but their growth might also pose a threat to public markets or to the values that we aim to further by maintaining and regulating them.²⁸⁹

A robust secondary market can play the beneficial role, discussed in Part II, of increasing liquidity in private company stock. This liquidity may be useful to the venture capital industry, which supports innovation and growth companies that provide a host of economic and technological benefits to society. The potential for liquidity may also help start-up companies with their fundraising, and it may bolster their ability to use stock options to recruit and retain employees.

The flip side, however, is that a robust secondary market might lead companies to choose to stay private longer or to avoid the public realm altogether.²⁹⁰ The need for liquidity has been a key reason for companies to

²⁸⁹ See Langevoort, *supra* note 254, at 11 (identifying as an issue “whether the [SEC] is willing to permit the kind of threat to the role of the organized exchanges that a deep and liquid market for private securities would pose”).

²⁹⁰ See Ronald D. Orol, *SEC Hints at Easing of Rules for Non-Public Trades*, WALL ST. J. MARKETWATCH (May 10, 2011), http://articles.marketwatch.com/2011-05-10/economy/30731548_1_secondmarket-private-shares-offering-rules (citing Professor John Coffee as arguing that private companies would continue to avoid going public if possible and that relaxing the rules for trading

go public; if secondary markets can increase the liquidity of private company stock, that incentive loses much of its force.²⁹¹

Indeed, the secondary markets explicitly aim to help companies stay private. The CEO of SharesPost explained:

Two of the biggest reasons to go public are to get liquidity for your existing shareholders and to gain efficient access to growth capital. We've stepped back and said, "Can we provide those two solutions for these companies?" And if so, give the companies the opportunity to go public over their time frame as opposed to "I've got a gun to my head." Now the companies have much more control over the process and timing of if and when they do a public listing.²⁹²

Similarly, the CEO of SecondMarket commented:

[T]he public markets [are] permanently broken. And I think there's an opportunity here to create an entirely new exchange, an entirely new marketplace that's good for companies . . . I think over time what you're going to see is more and more companies choosing to stay private and choosing to be a part of the new market structure that we've created.²⁹³

Further, SecondMarket was an "early and forceful advocate[]"²⁹⁴ for the JOBS Act reforms, which significantly raised the record-holder threshold for going public and eliminated the prohibition against "general solicitation" in private offerings.²⁹⁵ These reforms could help companies stay

private company stock "would hurt transparency, make the market less efficient and increase fraud").

²⁹¹ Cf. Richard A. Booth, *Going Public, Selling Stock, and Buying Liquidity*, 2 ENTREPRENEURIAL BUS. L.J. 649, 661-63 (2008) ("[O]ne of the primary benefits of going public is that it permits insiders to cash out of the business . . . [and] permits a company to use equity as compensation."); Sjostrom, *supra* note 31, at 641 ("Going public offers a company a number of advantages, including enhanced reputation, establishment of a market value for the company, and a broadened ownership base. For many companies, however, the primary advantages of going public are securing a large infusion of equity capital and attaining share liquidity." (footnote omitted)).

²⁹² Yarow, *supra* note 10.

²⁹³ Silbert, *supra* note 84, at 22:22-23:54; see also Ben Popper, *Forget Facebook, the IPO Market Is Dying, Says SecondMarket CEO Barry Silbert*, VENTUREBEAT (Jan. 17, 2012, 8:40 AM), <http://venturebeat.com/2012/01/17/secondmarket-facebook-ipo-private-shares-barry-silbert> (quoting SecondMarket CEO Barry Silbert as saying, "We want to create a market where anyone who is a 20 percent holder of a company with a valuation of \$150 million or more can get liquidity on their investment within two years").

²⁹⁴ *Q1 2012 Business Update*, SECONDMARKET (Apr. 16, 2012), <https://www.secondmarket.com/discover/reports/q1-2012-business-update>.

²⁹⁵ JOBS Act, Pub. L. No. 112-106, §§ 201 & 501, 126 Stat. 306, 313, 325 (2012).

private longer, and, as SecondMarket and SharesPost branch out to facilitating private placements,²⁹⁶ could allow for more aggressive marketing in the private capital raising process.²⁹⁷

It is no wonder that the secondary markets aim to help companies stay private, as the secondary markets may benefit when companies do so.²⁹⁸ The online markets are private companies themselves and receive fees for transactions.²⁹⁹ The greater the trading activity through their sites, the more money they make. Mature private company stock has been the most actively traded on the sites, and the sites suffer a blow when companies such as Facebook go public.³⁰⁰

However, from a policy perspective, there may be considerable downsides to robust private secondary markets that parallel public markets. Federal securities laws mandate registration, designed to protect investors and ensure confidence in the integrity of our capital markets.³⁰¹ Expanding exemptions and loosening strictures on sales of restricted stock increases the scope of securities issued and traded without the safeguard of registration.³⁰² The venture capital model uses a portfolio strategy that recognizes that many businesses will fail,³⁰³ but individual buyers might not sufficiently

²⁹⁶ See *supra* note 101 and accompanying text; see also Spears, *supra* note 89 (“SecondMarket . . . plans to raise money from its clients for at least eight different investment funds, run by outside managers . . .”). The JOBS Act also raised the offering limits under Regulation A from \$5 million to \$50 million and created a new exemption under the Securities Act for a type of capital raising known as “crowdfunding,” which uses the Internet to pool small individual contributions. JOBS Act §§ 301–402.

²⁹⁷ See, e.g., Spears, *supra* note 89 (noting that the elimination of the general solicitation ban “eas[es] the way for both SecondMarket and SharesPost to jump into that business”). Note that all actual purchasers of the securities must still be by accredited investors or QIBs. JOBS Act § 201.

²⁹⁸ See, e.g., J.J. Colao, *Breaking Down the JOBS Act: Inside the Bill That Would Transform American Business*, FORBES (Mar. 21, 2012, 11:08 AM), <http://www.forbes.com/sites/jjcolao/2012/03/21/jobs-act> (“Private secondary market companies like SecondMarket and SharesPost would benefit substantially from this reform [raising the shareholder cap to 2000], as it would likely lead to a larger, more robust market for the shares of private companies.”); Spears, *supra* note 89 (“The JOBS Act may also broaden the universe of stocks available for trading on these platforms. It allows companies to amass more shareholders while staying private.”).

²⁹⁹ See *supra* Section I.B.

³⁰⁰ See *supra* note 89 and accompanying text.

³⁰¹ See Daniel J. Morrissey, *The Securities Act at its Diamond Jubilee: Renewing the Case for a Robust Registration Requirement*, 11 U. PA. J. BUS. L. 749, 757–59 (2009) (describing the SEC’s objectives in requiring securities registration).

³⁰² *Id.* at 753.

³⁰³ See BURSTEIN & SCHWERIN, *supra* note 30, at 4, 8 (describing the typical venture investing strategy as “swinging for the fences,” with investments that are either “home runs or strike outs,” and noting that, in the last decade, venture capital dollars went into over 30,000 financing rounds for companies that never had a successful traditional exit).

diversify or understand the risks of investing in private companies.³⁰⁴ Further, the information that is available may give investors a false sense of security about the risks of investing and the accuracy of pricing.

And even if there is little concern for protecting accredited investors, there is reason to believe that private secondary market activity may affect retail investors. The Facebook IPO provides an example of how these two types of investors may be connected. According to its prospectus, Facebook relied on the market transaction method and “recent private stock sale transactions” as factors in determining its offering price valuation.³⁰⁵ In addition, its amended prospectus noted that a revision in its anticipated IPO price was influenced by “third-party private stock sale transactions in January 2012.”³⁰⁶ Thus the initial public offering price was set with reference to the share price on the secondary markets. Retail investors accounted for a significant amount of the stock bought in Facebook’s IPO.³⁰⁷

Even apart from the investor protection aspect of registration, many securities laws that apply to public companies, such as Sarbanes-Oxley and Dodd-Frank, are actually corporate governance laws as well. Companies that choose to stay private avoid not only registration, but also the reach of

³⁰⁴ In addition, smaller companies present a disproportionate risk of failure and fraud. See Jill E. Fisch, *Can Internet Offerings Bridge the Small Business Capital Barrier?*, 2 J. SMALL & EMERGING BUS. L. 57, 58 (1998) (“[R]egulators have identified small businesses as some of the riskiest investment opportunities.”). *But cf. supra* note 204.

³⁰⁵ Facebook, Inc., Registration Statement (Form S-1), at 63 (Feb. 1, 2012). The secondary markets may be encouraging reliance on their pricing data. SharesPost has made “real-time” pricing data for US-based private companies available on Bloomberg terminals. Press Release, Sharespost, SharesPost Data on Private Companies Now Included on Bloomberg Terminals (Nov. 9, 2011), available at <https://www.sharespost.com/bloomberg>.

³⁰⁶ Facebook, Inc., Amendment No. 8 to Form S-1 Registration Statement (Form S-1), at 78 (May 16, 2012); see also Shelly Palmer, *Facebook’s IPO: A View From The West*, SYS-CON MEDIA (May 23, 2012, 6:15 AM), <http://www.sys-con.com/node/2282015/> (“[T]he private market already signaled pricing to the public markets well in advance of the IPO so the banks had very little flexibility with pricing without facing sharp questions from either the company or the investors.”); Felix Salmon, *Facebook’s SecondMarket Muppets*, REUTERS (May 30, 2012, 9:57 PM), <http://blogs.reuters.com/felix-salmon/2012/05/30/facebook-secondmarket-muppets> (“[B]asic economic theory suggests that if a stock has buyers at \$44 privately, then its public value will be higher than that, since the universe of potential buyers expands enormously. Given that theory, it would have been really hard, I think, for Morgan Stanley to price the IPO below the levels seen on Second-Market for most of the previous year . . .”).

³⁰⁷ See Jean Eaglesham & Telis Demos, *Lawmakers Push for Overhaul of IPO Process*, WALL ST. J., June 21, 2012, at A1 (“Morgan Stanley [] allocated to retail investors 26% of shares, much higher than the 15% allocation in a typical IPO.”); Gretchen Morgenson, *Facebook Gold Rush: Fanfare vs. Realities*, N.Y. TIMES, May 20, 2012, at BU5 (“Indications are that Facebook was bought primarily by individual investors, not institutions. Indeed, institutions that had invested early were big sellers in the I.P.O.”).

many corporate governance provisions. Moreover, a host of other laws, such as the Foreign Corrupt Practices Act (FCPA),³⁰⁸ impose burdens on public companies not directly relating to disclosure or governance. Scholars have begun to explore ways of reconceiving the “publicness” of corporations that capture the dimensions beyond public reporting.³⁰⁹ The JOBS Act’s on-ramp provisions have also recently provided a glimpse into how public reporting obligations might be unbundled from governance and other obligations.³¹⁰ These developments demonstrate the need to grapple more fully and systematically with questions such as what additional burdens should be placed on different types of companies and whether line drawing should be done with reference to whether or not a company’s stock trades on a public market.

Finally, a separate concern surrounding the growth of the secondary markets for private company stock is that some perceive it as creating an exclusive private stock market for the wealthy. In this vein, finance writer Felix Salmon proclaimed, “To invest in younger, smaller companies, you increasingly need to be a member of the ultra-rich elite.”³¹¹ Small investors are shut out from directly investing in these growth companies.³¹² And

³⁰⁸ The FCPA prohibits bribery of a foreign official, party, or candidate to assist in obtaining or retaining business or securing any improper advantage, and requires that public companies keep accurate records of transactions and payments and maintain a system of internal controls. 15 U.S.C. § 78dd-1(a) (2006).

³⁰⁹ See Langevoort & Thompson, *supra* note 235, at 43 (exploring the public-private company divide and arguing that “a distinct class of systemically significant public issuers” should be created that enjoys a different level of regulation than other issuers); Hillary A. Sale, *The New “Public” Corporation*, 74 LAW & CONTEMP. PROBS. 137, 139-40 (2011) (arguing that the definition of a corporation as public by reference to whether it trades on a public market is “impoverished” and that “the government and the media have increasing influence over public corporations and their governance”).

³¹⁰ The JOBS Act on-ramp provides that a list of Exchange Act obligations otherwise imposed on public companies will not apply until five years after a company’s IPO, unless the company either passes \$1 billion in annual revenues or reaches a certain market capitalization. JOBS Act, Pub. L. No. 112-106, §§ 101–108, 126 Stat. 306, 307-13 (2012); *see also supra* note 41.

³¹¹ Salmon, *supra* note 23; *see also* Felix Salmon, *The Downside of Companies Staying Private*, REUTERS (Mar. 22, 2011), <http://blogs.reuters.com/felix-salmon/2011/03/22/the-downside-of-companies-staying-private> (arguing that limiting investment in private companies creates “a world where most companies are owned by a small group of global plutocrats, living off the labor of the rest of us”); *The Endangered Public Company: Rival Versions of Capitalism*, ECONOMIST, May 19, 2012, available at <http://www.economist.com/node/21555562> (“[P]ublic companies give ordinary people a chance to invest directly in capitalism’s most important wealth-creating machines . . . The rise of private equity and the spread of private markets are returning power to a club of privileged investors.”).

³¹² The Facebook IPO provides an interesting example of the media drawing attention to the idea that certain wealthy investors and institutions have the opportunity for large gains before the

despite the fact that pre-IPO investments are not guaranteed to make money, many commentators have predicted that the secondary markets will nonetheless continue to exist because “investors have little choice but to tread into the private markets if they want to invest in the rapid-growth stages of new tech companies.”³¹³ Apart from indirect investments,³¹⁴ however, unaccredited retail investors cannot tread into these private markets.

This concern about a stratified market structure is, of course, in tension with the investor protection goals that are served by limiting access to the private markets in the first place.³¹⁵ As such, it perhaps serves as a useful

stock is available to the public. *See, e.g.*, Daniel Fisher, *Did Hedge Funds Steal the Facebook IPO Pop?*, FORBES (May 21, 2012, 2:49 PM), <http://www.forbes.com/sites/danielfisher/2012/05/21/did-hedge-funds-steal-the-facebook-ipo-pop> (noting that VCs are selling late-stage private company stock to hedge funds, private equity firms, and wealthy investors and that the IPO “pop” is a “casualty” of companies taking longer to go public); Daniel Gross, *Facebook’s IPO Already Happened—Several Months Ago on SecondMarket*, YAHOO! FIN. (May 21, 2012, 9:44 AM), <http://finance.yahoo.com/blogs/daniel-gross/facebook-ipo-already-happened-several-months-ago-secondmarket-134457488.html> (“Thanks to SecondMarket, big-shot investors no longer have to wait until an IPO to express their enthusiasm about a company. And that means the froth and pop that used to take place exclusively on the NASDAQ or the NYSE in the opening trading days can now take place weeks or even months before the official IPO. That’s clearly what happened with Facebook.”); Derek Thompson, *If Facebook’s Profit Model Stays the Same, This Valuation Doesn’t Make Any Sense*, ATLANTIC (May 18, 2012, 1:29 PM), <http://www.theatlantic.com/business/archive/2012/05/if-facebooks-profit-model-stays-the-same-this-valuation-doesnt-make-any-sense/257396/> (“If [you] want something that’s going to have explosive growth, you should have invested in Facebook a long time ago [on the secondary market].”).

³¹³ Joe Light, *Facebook: What’s Next for Secondary Markets*, WALL ST. J. TOTAL RETURN (June 7, 2012, 11:55 AM), <http://blogs.wsj.com/totalreturn/2012/06/07/facebook-whats-next-for-secondary-markets>; *see also* Tom Foremski, *In Facebook IPO Fiasco the ‘Smart Money’ Got Burnt*, ZDNET (May 25, 2012, 11:34 AM), <http://www.zdnet.com/blog/foremski/in-facebook-ipo-fiasco-the-smart-money-got-burnt/2280> (“The Facebook fiasco . . . should be good news for private stock markets such as SharesPost and Second Market [sic] because tech IPOs will be cutback leaving these markets in a great position as the only alternative to being acquired.”).

³¹⁴ Global Silicon Valley Corp. provides an example of such an indirect investment opportunity. It is a publicly traded, closed-end mutual fund, which has bought private company stock in private secondary transactions. *See* Tomio Geron, *GSV Capital Investment Values Facebook at \$70 Billion*, FORBES (June 27, 2011, 1:38 PM), <http://www.forbes.com/sites/tomiogeron/2011/06/27/gsv-capital-investment-values-facebook-at-70-billion> (noting that the Global Silicon Valley Corp. mutual fund included shares of then-private Facebook in its portfolio).

³¹⁵ For a similar example of competing values, consider the public reaction to the JOBS Act’s “crowdfunding” exemption, which allows for web-based fundraising in relatively small amounts from many unaccredited investors. The crowdfunding bill democratized some private company investing but came under fire from consumer advocates, media commentators, regulators, and academics for eliminating investor protections and potentially fostering fraud. *See, e.g.*, Luis A. Aguilar, Comm’r, SEC, Public Statement, *Investor Protection Is Needed for True Capital Formation: Views on the JOBS Act* (Mar. 16, 2012), available at <http://www.sec.gov/news/speech/2012/spcho31612laa.htm> (criticizing the JOBS Act and noting consumer advocates and other

reminder that as the private secondary markets develop and change, it will be important to monitor their relationship to public markets. Furthermore, this discussion underscores that proposals for reform, such as this Article's proposal for moderate constraints to respond to information issues, may need to be revisited as a balance develops in the broader securities regulation context between public and private markets and companies, and between investor protection, market integrity, capital formation, and other societal interests.³¹⁶

CONCLUSION

New online marketplaces for secondary trading of private company stock may help to increase liquidity at a time when the venture capital industry and other investors have struggled with the lengthening time it takes start-up companies to go public or be acquired. The new marketplaces face significant information issues, however, that threaten their legitimacy and efficiency. The goal of this Article is to identify and examine these information issues—lack of information, asymmetric information, conflicts of interest, and insider trading—as well as provide potential responses that would allow the markets to continue to evolve, while promoting their integrity and serving investor protection goals. Looking ahead, the development of these markets should be followed with interest as they help shape the divide between public and private companies and markets.

organizations that had expressed concerns about removing investor protections); *Spurring Job Growth Through Capital Formation While Protecting Investors: Hearings Before the S. Comm. on Banking, Hous., and Urban Affairs*, 112th Cong. 10 (2011) (statement of John C. Coffee, Jr.) (noting that without his suggested changes or a similar variant, “every barroom in America could become a securities market, as some unregistered salesman, vaguely resembling Danny DeVito, could set up shop to market securities under the ‘crowdfunding exemption’”); Robb Mandelbaum, *Which Crowdfunding Bill Will It Be?*, N.Y. TIMES YOU’RE THE BOSS (Mar. 27, 2012, 1:33 PM), <http://boss.blogs.nytimes.com/2012/03/27/which-crowdfunding-bill-will-it-be/> (“The most ballyhooed part of the House JOBS bill . . . is the so-called crowdfunding proposal . . . Opportunities to defraud unsuspecting investors . . . may be vast if the House version of the bill survives.”); Felix Salmon, *The Problematic JOBS Act*, REUTERS (Mar. 21, 2012), <http://blogs.reuters.com/felix-salmon/2012/03/21/the-problematic-jobs-act/> (“The crowdfunding (a/k/a crowd-muppeting) part, for instance, seems very badly thought out . . .”).

³¹⁶ See Paredes, *supra* note 178, at 1005 (discussing the delicate balance between regulating for investor protection, promoting capital formation and investor confidence, and impeding capital formation with aggressive oversight and enforcement).